

No. 16,010

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**In the United States Court of Appeals  
for the Ninth Circuit**

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**GENE O. CLARK AND FAYE CLARK, PETITIONERS**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

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**On Petition for Review of the Decisions of the  
Tax Court of the United States**

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**BRIEF FOR THE RESPONDENT**

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**OPINION BELOW**

The opinion of the Tax Court (R. 52-145) is not officially reported.

**JURISDICTION**

This petition for review involves the liability of the taxpayer, Gene O. Clark, for deficiencies in income taxes amounting to \$24,151.53 and statutory additions thereto (50% fraud penalties) in the amount of \$12,075.77, assessed against him for his calendar years 1946 and 1947 (R. 14-15), and the liability of his wife, Faye Clark, for an income tax deficiency assessed against her in the amount of \$12,252.87 for her calendar year 1947 (R. 35).

These deficiencies and penalties were redetermined by the Tax Court in the total decreased amounts of \$20,893.80 and \$10,446.91, respectively, for the taxpayer Gene Clark's calendar years 1946 and 1947 (R. 160), and in the decreased amount of \$9,288.48 for the taxpayer, Faye Clark, for her calendar year 1947 (R. 161). Notices of the deficiencies and statutory additions thereto were mailed to the taxpayers, separately, on February 20, 1953. (R. 10, 30.) On May 20, 1953, within the permitted 90-day period, the taxpayers filed petitions for review with the Tax Court for a redetermination of the deficiencies under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 6-15, 27-35.) The Commissioner filed answers (R. 16-22, 36-42); the taxpayers filed replies (R. 22, 42); the taxpayers filed motions to amend their petitions (R. 23-24, 43-44) and amended same on April 1, 1955 (R. 25-26); and the Commissioner filed answers to the amended petitions (R. 26, 45). A hearing was held on March 28 through April 1, 1955, at Los Angeles. (R. 46.) The decisions of the Tax Court sustaining the deficiencies and penalties, as adjusted, were entered on November 21, 1957. (R. 160, 161.) Petition for review by this Court were timely filed on February 10, 1958. (R. 162-166, 166-170.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1939.

### QUESTION PRESENTED

Did the Tax Court err, under the entire record here presented, in sustaining: (a) Both income tax deficiencies and civil fraud penalties assessed against Gene Clark for his calendar years 1946 and 1947; and (b) an income tax deficiency assessed against Faye Clark for her calendar year 1947.

### STATUTES INVOLVED

The pertinent statutes and Regulations are set forth in the Appendix, *infra*.



## STATEMENT

The facts, as stipulated (R. 172-175) and found by the Tax Court below (R. 55-83), appear, as follows:

The taxpayers, Gene O. and Faye Clark, are husband and wife, and during the calendar years 1946, 1947 and 1948 resided in Los Angeles County, California. In March 1949, they moved to Independence, Kansas, and for the remainder of the year were residents of Kansas. All income derived by the taxpayers during the years 1946 to 1948, inclusive, was community income. For the calendar years 1946 and 1947, they filed separate income tax returns on the community property basis and for the calendar year 1948, they filed a joint return with the Collector of Internal Revenue of Los Angeles, California. For the year 1949, they filed a joint income tax return with the Collector of Internal Revenue for the District of Wichita, Kansas. (R. 55-56.)

Prior to April 23, 1946, Gene O. Clark (hereinafter sometimes called the taxpayer) and Archie Koyl were associated in a business venture known as Gene Clark Plumbing Company (hereinafter sometimes referred to as the Plumbing Company), consisting of two shops, located in El Monte and Bell Gardens, California, and having a labor force of approximately thirty-five employees. The Plumbing Company was engaged primarily in selling plumbing supplies and rendering plumbing services to building contractors. No certificate for doing business under a fictitious name was filed on behalf of Plumbing Company to show that it was a partnership. (R. 56.)

The taxpayer and Archie Koyl organized a California corporation, Gene O. Clark, Inc., now known as Atlas Pipe and Supply Company (hereinafter sometimes called the corporation), on April 23, 1946,<sup>1</sup> to engage in the wholesale plumbing business. Of the 522 shares of \$100

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<sup>1</sup> Although the parties repeatedly refer to the date of incorporation as May 1, 1946, the record shows that the official date of incorporation was April 23, 1946.

par value stock authorized, 364 shares were issued to the taxpayer, president of the corporation, and 157 shares to Archie M. Koyl, vice president. One qualifying share was issued to another individual who is not involved herein. The taxpayer acquired his shares at a cost of \$36,500. The taxpayer's shares represented an ownership interest in the corporation of approximately 70 per cent. (R. 56-57.)

On or about March 29, 1948, the taxpayer purchased the 157 shares of stock owned by Koyl for \$24,714.49. The sale of Koyl's interest therein was consummated by a document designated "Assumption of Obligation," dated March 29, 1948, filed as the taxpayer's Exhibit 29. (R. 57.)

Thereafter, in December 1948, Clark informed Koyl that he desired to sell out his entire interest in Gene Clark, Inc., to Koyl. On or about March 1, 1949, Clark sold all of his stock to the Koyls, 262 shares to Archie and 260 shares to Fawn, a total of 522 shares. (R. 57.)

During the fiscal years ended April 30, 1947, to 1950, inclusive, the proportional stock ownership in Gene Clark, Inc., is summarized as follows (R. 57):

<u>Date</u>	<u>Clark</u>	<u>Koyl</u>
April 23, 1946 to March 31, 1948	70%	30%
March 31, 1948 to March 1, 1949	100%	
March 1, 1949 to April 30, 1950		100% <sup>2</sup>

Gene Clark, Inc., commenced its business operations on or about April 23, 1946, occupying the same premises as the Plumbing Company. Within a few months after the formation of the corporation, the inventory of the Plumbing Company and that of the corporation were commingled and were thereafter kept as a single unit. The only employees on the business premises were those of the corporation. No records were kept that could properly reflect business transactions of any plumbing enterprise other than the corporation. The only book kept in the office that had any connection with Plumb-

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<sup>2</sup> Including shares of Fawn Koyl.

ing Company was a check book on the Bank of America in El Monte. No federal tax returns were filed on behalf of Plumbing Company for any period after April 23, 1946. (R. 58.)

Plumbing Company existed, however, for an indeterminate period after the organization of the corporation, solely for the purpose of buying and selling plumbing materials in violation of the then existent regulations of the Office of Price Administration (O.P.A.). This was done because Plumbing Company did not hold any license to do business which could be forfeited if it were found guilty of violating O.P.A. regulations. Plumbing Company was to serve as a front in such transactions for the corporation which did hold a license to do business. (R. 58.)

The corporation kept its books on an accrual method and reported its income on a fiscal year basis beginning with the year ending April 30, 1947. (R. 58.)

After incorporation of the plumbing enterprise, customers would frequently make out checks to Gene Clark, to the corporation or to Plumbing Company. To obviate the resultant confusion, the corporation adopted a rubber stamp showing all three designations in order that it might properly endorse any check. This composite stamp was used throughout the period here in question. (R. 58-59.)

During each of the taxable years in which Clark was an officer and stockholder of Gene Clark, Inc., substantial but undisclosed and undetermined amounts of receipts from sales made by the corporation were neither recorded on its books nor reported on its income tax returns. During the fiscal years involved herein, the net income of Gene Clark, Inc., reported on its returns (the tax liability of which is material here because of its reflection upon the issues involving the taxpayers) the total additions to its net income as found by the revenue agent, and its total net income as so found are as follows (R. 59):<sup>3</sup>

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<sup>3</sup> The additions to net income and the total net income here listed were predicated upon the computations contained in a report pre-

Year	Net Income per Returns	Additions to Net Income per Revenue Agent's Report	Total Net Income per Revenue Agent's Report
1947	\$30,632.10	\$102,050.17	\$132,682.27
1948	16,726.40	92,208.62	108,935.02
1949	(4,154.03)	46,575.16	42,421.16

Joint Exhibits 3-C, 1-A, and 2-B are, respectively, the revenue agent's reports on Gene Clark, Inc., for the fiscal years ending April 30, 1947-1949, inclusive; the taxpayers' separate returns for 1945, 1946 and 1947; and the taxpayers' joint returns for 1948 and 1949. (R. 60.)

Up to March 1, 1949 (when he sold out his entire interest to the Koyls), the taxpayer was in general control of the over-all corporate operations and dictated its financial policies. Clark was in full charge of the main office in El Monte. Archie Koyl directed the activities at the shop in Bell Gardens. Virtually all other corporate activities, including the maintenance of corporate records and the disposition of receipts, were under the direct control of the taxpayer. (R. 60.)

Fred Files, comptroller and office manager of the corporation, worked under the immediate supervision and direction of the taxpayer. Files' duties consisted primarily of handling receipts and keeping proper office records. He worked at both shops, keeping one set of books for the entire operation, though consecutively numbered duplicate receipt books were maintained in both shops. When cash was received from a customer, the amount thereof was recorded in the receipt book which was, in substance, merely a memorandum that was later transferred to the "cash receipts" journal in the books

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pared by the Commissioner's agent during the investigation of the income tax liability of Gene Clark, Inc., which report (discussed, *infra*), was received in evidence by stipulation of the parties for the purpose of explaining the basis of the Commissioner's ultimate determination, but not as evidence of the facts contained therein.



of account. Cash sales were sometimes totalled daily and sometimes only several times a week. A single "cash receipt" figure was usually recorded in the journal for the total amount of the separate sales. Deposits of the total cash receipts were made in the corporation's bank account and generally recorded weekly in the cash receipts journal. Files, who handled all of the bank deposits of the corporation, regularly deposited all cash receipts of the corporation which were turned over to him for such purpose by Gene Clark. On a number of occasions, however, Gene instructed Files to set aside the cash proceeds from certain sales and to turn such funds over to him without recording the sales on the books. Also, at different times, the taxpayer would give Files checks made out to the corporation by customers for sales, which sales were unrecorded on the corporate books, in exchange for the cash taken by the taxpayer. An undetermined part of such cash proceeds were used by the officer-stockholder to cash checks as an accommodation for neighborhood stores and workmen in relatively small sums ranging up to \$100. There was a substantial but undetermined difference in the amount of cash Files recorded in corporate books or deposited in its bank accounts and the amount of cash sales actually made by the corporation. The aforementioned method of handling cash sales was also the general practice of Plumbing Company and was not altered by the coming into existence of the corporation during the entire taxable period involved herein. (R. 60-61.)

Between May, 1946, and December, 1946, the taxpayer, on behalf of the corporation, frequently sold and shipped plumbing materials from the El Monte yard without any entry being made for the transactions in the corporate records. Some of such shipments represented "trading transactions" or nonprofit exchanges of materials with competitors for mutual convenience. (R. 61-62.)

Subsequent to December, 1946, the taxpayer frequently sold and traded plumbing equipment on behalf of the corporation. He also sold and traded used vehicles.

Files was not supplied with the appropriate sales slips and proceeds on many of these transactions. Sometimes Clark would simply give the comptroller a check, without adequate details connected with the sale, and instruct him to remove the particular asset from the corporate books. (R. 62.)

During 1947, when maximum ceiling price regulations on plumbing supplies were in effect under the Office of Price Administration, Clark engaged in black market activities. When he dealt in such illicit activities, the taxpayer would generally pay an undisclosed amount of cash for the purchase of materials over the price indicated on the invoice. These cash funds were taken from unreported corporate receipts. The over-ceiling cash payment was not recorded on the corporate books as part of the total cost of the illicit purchases. Neither the taxpayer, Plumbing Company, nor the corporation reported the profits from such illegal sales transactions. (R. 62.)

During each of the taxable years in question, the taxpayer also had an arrangement with Keenan Pipe and Supply Company whereby he was able to purchase materials on behalf of the corporation at one-third off for cash. Under this arrangement, indeterminate amounts of such purchases were made and paid for (usually with receipts obtained from unreported corporate sales), the parties agreeing not to keep any records of their cash transactions. (R. 62-63.)

Apart from the foregoing *modus operandi* during each of the years involved herein, Gene Clark, Inc., made numerous purchases of plumbing materials in the normal course of business which were not recorded on the corporate books, but the subsequent sales thereof were likewise unrecorded. Also, in many instances, the profits from such sales were neither reported by the corporation on its income tax returns nor by the taxpayers on their returns for the years in issue. The corporation also rendered plumbing services for building contractors on a number of housing projects during the years in ques-

tion, and the taxpayer failed to record the full receipts therefor on its books. (R. 63.)

### **Y. L. Creed Transaction**

Between December 1945 and March 1946, Gene Clark performed extensive plumbing work for Y. L. Creed, a general contractor, on four houses being constructed in Maywood, California. Creed agreed to pay a total of \$2,922.50 for such services, of which the first payment was made by a check in the sum of \$544, on February 5, 1946. The same day, the check for \$544 was deposited to the account of Gene Clark Plumbing Company, and recorded in the sales of that company. The remaining \$2,378.50 was credited to the taxpayer by Creed in June 1946, on account of the purchase price of a house (5957 Otis Avenue, Maywood, California) which the taxpayer purchased from him for a total consideration of \$8,500. The balance of the purchase price was represented by a trust deed made out in favor of Creed and a cash payment of \$1,400 placed in escrow by Clark. The credit of \$2,378.50 was not reported on the income tax return of Gene Clark or Gene Clark, Inc. The Plumbing Company filed no return for this period. (R. 63-64.) See paragraph (3) under heading "Matters Relating to Earnings and Profits Available for Distribution," *infra*.

### **Unreported Transactions—Gene Clark, Inc.**

On October 5, 1946, Gene Clark, Inc., and Truman Johnson, a building contractor, executed a contract under which the corporation was to supply plumbing materials and services to Johnson on ten new houses in West Covina, California. The contract price set forth in the written contract was \$3,300, but the actual price was \$9,300. (On January 22, 1947, the parties executed another contract for similar services on a housing project, consisting of forty houses being built in West Covina at a cost of \$930 per house or a total of \$37,200.) About the same time it rendered these plumbing services to

Johnson, Gene Clark, Inc., purchased a house from him for a total price of \$22,000. The price per unit of the ten houses to be serviced under the October 5, 1946, contract was \$930 per house. The difference of \$6,000 between the written contract price of \$3,300 and the actual (though unexpressed) contract price of \$9,300 represented part payment on the house which the corporation purchased from Johnson. The corporation was credited by Johnson with the difference of \$6,000 on the purchase of the house in 1946. Likewise, Johnson's books reflected the full cost of the materials and services furnished, including the \$6,000 in question. The transaction was handled in the foregoing manner at the request of the taxpayer. The \$6,000 credit was neither recorded on the books of Gene Clark, Inc., nor reported on the corporate income tax returns for any year involved herein. In September 1947, the corporation sold the house to Clark at an amount which was about \$3,137.90 less than the actual cost. The amount of the selling price to Clark was set up as an account receivable on the books of the corporation. (R. 64-65.)

In the year 1947, the following amounts were received by Gene Clark, Inc., from Hamilton Homes, Inc., for plumbing material and services, which were not included in the sales of Gene Clark, Inc. (R. 65):

<u>Date</u>	<u>Amount</u>
9/10/47	\$1,221.00
9/16/47	2,295.00
7/ 9/47	2,170.00

A receipt for \$8,241.42, dated September 16, 1947, was issued to Gene Clark with the notation "Payment in full for Equity in House at 1825 Vine," and the amount thereof was credited to Gene on the "Accounts Receivable—Officers" account of Gene Clark, Inc., by entry dated September 30, 1947. On September 16, 1947 (the same day the receipt for \$8,241.42 was issued to the taxpayer), the corporation made a bank deposit in its commercial bank



account at Citizens National Bank of Maywood, California, in the amount of \$21,180.51, which included, in addition to an undisclosed amount of cash, two of the three checks (in the respective amounts of \$1,221 and \$2,295) representing unrecorded sales received from Hamilton Homes, Inc. The third check for \$2,170 was deposited by the corporation on July 30, 1947, as part of a deposit in the amount of \$10,016.46. The three checks from Hamilton Homes, Inc., were substituted for other receipts from sales recorded on the corporate books but not deposited. (R. 65-66.)

Gene Clark, Inc., received a check dated September 15, 1947, in the amount of \$1,000 from H. K. Niles, which was not reported in the corporate books as a sale, but was included in the corporation's bank deposit of September 16, 1947, mentioned above, in the amount of \$21,180.51. This check was likewise an item substituted for other sales recorded on the books but not deposited. (R. 66.)

The following checks were also received by the taxpayer on behalf of the corporation for materials and plumbing services (R. 66):

<u>Payable to</u>	<u>Amount</u>	<u>Date</u>	<u>Payor</u>
Gene Clark (endorsed "Gene Clark")	\$1,558.44	4/20/48	Ben Lang
Gene Clark	2,294.50	1/14/48	Allen T. Mitchell & Son
Gene Clark Plumbing Co.	1,158.44	2/10/48	A. & F. Plumbing & Heating Co.

It was stipulated (R. 228, 296) that the above amounts were not entered on the books and records of the corporation as sales, nor were they reported for tax purposes on the income tax returns of the corporation or of the taxpayers for the years in issue. (R. 66-67.)

It was likewise stipulated (R. 295) that during 1948, the taxpayer received the following amounts, totalling \$38,009.74, from Lloyd H. Meissenberg, of George A. Meissen-

burg (Valley Boulevard Plumbing & Electric Company), plumbing contractors, for plumbing materials, which amounts also were not recorded in the corporate records or reported on the income tax returns of either Gene Clark, Inc., or the taxpayers for any of the years involved herein (R. 67):

<u>Method of Payment</u>	<u>Date</u>	<u>Amount</u>	<u>Payable to</u>	<u>Endorsed by</u>
Check	2/9/48	\$22,935.00	Gene Clark	Gene Clark
Check	1/29/48	3,074.74	Gene Clark	Gene Clark
Cash	3/2/48	12,000.00		

Of the total of \$38,009.74 received as above noted, Clark retained approximately 70 per cent and gave Koyl approximately 30 per cent. (R. 67.)

A check in the amount of \$1,700 (Tr. 94-95, 96) received by the corporation (made payable to Gene Clark) in payment for one of its vehicles, was drawn by Walter A. Story on February 12, 1948. There is no evidence in the record that the check was entered on the books of the company. (R. 67.)

On March 4, 1948, the taxpayer received a check (stipulated, R. 295) in the amount of \$6,670 from the Southern California Investment Company for rough plumbing (on some twenty-three houses at \$290 per unit) payable to Gene Clark, Inc. The check for \$6,670 was endorsed "Gene Clark, Inc., Gene Clark" and cashed March 19, 1948. A cashier's check in the amount of \$6,670 payable to Gene Clark, Inc., was acquired the same date and was deposited March 31, 1948, in the commercial bank account of Gene Clark, Inc., at Citizens National Bank, Maywood, as part of an over-all deposit of \$12,816.85. The receipt of the \$6,670 was not recorded as a sale in the records of Gene Clark, Inc., nor was it reported as income by either the corporation or the taxpayers. The deposit of the cashier's check of \$6,670 was in substitution for other receipts recorded on the books of Gene Clark, Inc., but

not deposited in the corporation's bank account. (R. 67-68.)

On March 20, 1948, the day after the cashier's check was acquired, Gene Clark, Inc., received a total amount of \$6,610 in cash from the following four separate transactions, for each of which the corporation comptroller issued a cash receipt. The corporation received \$1,250 in cash from the sale of a 1947 Chevrolet truck. The transaction was reported in the corporation's return for fiscal year 1948 as a sale of assets. The amount of \$1,473.93 in cash was also received from Story and Sons and that sum was credited to their account on the books of the corporation. Likewise, the corporation received the sum of \$2,099.91 from Las Vegas Supply Company for the sale of certain miscellaneous assets which was credited on the corporation books. The amount of \$1,786.16 was received from Clark and credited to him in the "Accounts Receivable—Officers" account. There is no evidence that the cash items totalling \$6,610 (R. 292-293) were deposited in the corporation's bank account as a part of the deposit of March 31, 1948, or at any other time. (R. 68-69.)

Gene Clark, Inc., constructed a swimming pool at La Jolla, California for James M. Young, Jr., and received the following checks (R. 69):

<u>Date</u>	<u>Amount</u>
10/30/47	\$1,672.75
11/26/47	1,672.75
11/ 6/47	1,672.75
1/24/48	1,902.73

The first three checks listed above were credited to the account receivable ledger card of James M. Young. It was conceded on brief before the Tax Court that the last check in the amount of \$1,902.73, endorsed by the taxpayer, was neither recorded on the books of the corporation, deposited in its bank account, nor reported as income on its tax return for fiscal 1948. (R. 68.)

The taxpayer, on behalf of Gene Clark, Inc., received the following check for plumbing material sold by the corporation to the Valley Cities Supply Company (R. 69):

<u>Date</u>	<u>Payable to</u>	<u>Endorsed by</u>	<u>Amount</u>
9/20/47	Gene Clark	Gene Clark, Archie Koyl	\$2,731.54

It was stipulated (R. 295) that the above check was neither entered on the books of Gene Clark, Inc., as sales, nor reported for tax purposes on either the income tax returns of the corporation or of the taxpayers for the years in question. (R. 69.)

### **“Accounts Receivable—Officers,” Farm Purchases**

During 1946, Gene Clark took a trip to Kansas to examine some farm land, intending to purchase it for the corporation to own and operate. After locating a farm known as North Farm, in Montgomery County, Kansas, he purchased it for a total price of \$40,000, making a down payment of \$10,000 which he borrowed from the Valley Cities Supply Company. When the directors of Gene Clark, Inc., were advised that the corporation was not permitted to own such land in Kansas, they rejected the proposed purchase of North Farm. The taxpayer then decided to purchase the farm land in his own name, using corporate funds as part of the consideration. As part of his financial arrangements relating thereto, the taxpayer, on July 31, 1946, had set up account #110 on the corporate books designated as “Notes Receivable” and an entry was made indicating a loan of \$10,000 had been extended to Clark and Koyl. Thereafter extensive withdrawals were debited to the account in 1946 in relation to the farm purchases, and will be referred to *infra*. These withdrawals were made by Clark without provision for promissory notes, security or interest. There are two credit items in 1946, which, as explained by journal entry, merely reflect a transfer to another account (Outside Investment—West



Covina Property). There is a debit in 1947 to Valley Cities Supply Company which is balanced by a credit within a month. There is also a debit of \$1,591.83 dated February 28, 1947, which is unexplained. None of the credits purport to be cash payments by Clark (or Koyl) except the \$20,000 item of April 30, 1948, in the so-called trust deeds account which was a spurious credit. The circumstances surrounding it and the use of the "Trust Deeds" as the title of the account are set forth *infra*. (R. 70-71.)

Originally, when it was decided that the corporation would own and operate North Farm, the board of directors had opened an account with the Citizens National Bank of Los Angeles, California, designated "Special Account No. 1," in the amount of \$5,000. However, after it was learned that the corporation could not operate the farms, on December 31, 1946, the \$5,000 deposit in the account was transferred to the "Notes Receivable—Officers" account as a debit to Clark's individual account. (R. 71.)

Soon after the purchase of North Farm, Koyl indicated that he would like to own a farm. The taxpayer thereupon bought another farm in Kansas for Koyl, known as South Farm, consisting of about 350 acres. As part of the purchase price therefor, Clark obtained approximately \$10,000 by selling plumbing materials belonging to the corporation. In addition, on August 31, 1946, a charge to the "Notes Receivable—Officers" account was made in the amount of \$11,406.80, and again on October 31, 1946, another charge of \$12,420.66 was made in connection with the purchase of the farms. (R. 71.)

As of May 1, 1947, the "Notes Receivable" account shows debit balances of \$25,304.50 for Clark and \$10,844.79 for Koyl, totalling \$36,149.29. The balances were in direct proportion to their respective shareholdings in the corporation. (R. 71-72.)

Some time before May 1, 1947, the designation of the "Notes Receivable—Officers" account on the general ledger was scratched out (for some unexplained reason) and

changed to "Trust Deeds." A schedule denominated "Notes Receivable—Officers," attached to the corporation's return for fiscal year 1947, states, *inter alia*, that after it was learned that North Farm in Kansas could not be purchased by Gene Clark, Inc., the corporation extended a loan to the officers and "authorized the Officers to purchase this land in their names. The corporation received in return Trust Deeds and Signed Notes [Sic] as security until such time as the land can be profitably sold" At no time while Clark was affiliated with the corporation did it own any trust deeds, and except for the erroneous heading of the account, the corporate books do not reflect such ownership. (R. 72.)

In 1948, the taxpayers purchased two other farms in Kansas for a total price of \$70,000, and for such purpose borrowed \$28,000 from the Independence Bank in Kansas on February 5, 1948, payable in five years. The loan was repaid September 26, 1950. (R. 72.)

In March 1949, title to South Farm, owned by Koyl, was transferred to Clark. (R. 72.)

Pursuant to the specific instructions of the taxpayer, the comptroller sometimes made entries in the corporate books which did not reflect the true facts or amounts involved in the particular transactions being recorded. Thus, during 1948, when Gene Clark Inc., declared its first and only formal dividend, the taxpayer received a dividend check in the amount of approximately \$20,000 (to be exact \$19,996.17). The taxpayer reported the receipt of the dividend on his joint return for 1948. On April 30, 1948, after Clark received the dividend check, his "Notes Receivable—Officers" account was credited with \$20,000. The taxpayer, however, did not turn back the dividend check to the corporation as a credit toward the account. Instead, Clark turned over to the corporation comptroller customers' checks, substantial in amount, totalling about \$20,000, with instructions to credit the account. (R. 72-73.)

### **Matters Relating to Earnings and Profits Available for Distribution**

The deficiencies in the instant case were predicated upon the computations contained in an exhaustive report prepared by the Commissioner's agent during the investigation of the income tax liability of Gene Clark, Inc., for the fiscal years 1947 through 1950, inclusive, the report being admitted in evidence by stipulation of the parties to show the basis of the Commissioner's determination. Corporate net income and tax liability were computed largely upon the bank deposit method, gross receipts being determined primarily on the basis of unreported sales and deposits in the various bank accounts of the corporation. Also, numerous deductions reported by the corporation on its returns as ordinary and necessary business expenses were disallowed. (R. 73.)

The Commissioner, being unable to ascertain with exactitude the amounts of diverted funds attributable to Clark and Koyl, respectively, during the years in issue, allocated such diversions on the basis of their respective stock ownership in the corporation, 70 per cent of the unreported corporate funds being attributed as informal or constructive dividends to the taxpayers. (R. 74.)

The manner in which respondent determined those amounts ultimately attributed to the officer-stockholders as informal dividends for each of the years in question was to first ascertain the earnings and profits of the corporation, as indicated above, and then to adjust this figure for so-called "unavailable" items, thus arriving at the amount "actually" available for distribution as constructive dividends. (R. 74.)

Many items included in the revenue agents' report were admitted by counsel for the taxpayer to be correct at the time the report was submitted in evidence and in part are set forth in detail above. A number of other items connected with the unreported sales of the corporation were contested by the taxpayer, either at the trial or on brief before the Tax Court. (R. 74.)

The Tax Court's findings of fact with respect to those items relating to earnings available for distribution which were disputed (except for items disposed of because of failure of the taxpayer to sustain the burden of proof and items fully covered above in the Tax Court's findings) are as follows (R. 74-80):

**(1) *Corporate earnings per return***

The net income per return of the corporation, as set forth hereinbefore, is properly includible in computing earnings available for distribution as dividends for each of the taxable years in controversy. (R. 75.)

**(2) *Substitutions***

As aforementioned, during the years 1946 through 1949, inclusive, substantial amounts of receipts from sales were neither recorded on the books of Gene Clark, Inc., nor reported in its income tax returns. In some instances, no part of the particular sales was recorded or reported. In others, less than the full amount was recorded or reported. One device used was referred to in the testimony as "substituted" sales. The device operated substantially as follows: Cash sales would be made and recorded on the books. Other sales totalling a like amount would be made, for which checks were received in payment, which were not recorded on the books. The proceeds of the latter sales, though not recorded, would be deposited, but the recorded cash sales would not be deposited. As a result, the deposit would equal the recorded sales, but an equal amount of sales would be unrecorded and unreported. (R. 75.)

The taxpayer also cashed checks as an accommodation for neighborhood stores and workmen in relatively small sums ranging up to \$100, and an undisclosed number of such checks were deposited in the various corporate bank accounts. (R. 75.)

Apart from such "accommodation" checks, the aforementioned checks, representing unreported sales, were



“substituted” for the “cash receipts” and deposited in corporate bank accounts, and are includible in corporate gross income. The Tax Court reduced the amount of the substituted items (R. 91) so that the amounts reflected in the revenue agents’ report, and the amounts as adjusted compare as follows (R. 75-76):

<u>Fiscal Year</u>	<u>Amount per Report</u>	<u>Amounts as Adjusted</u>
1947	\$14,806.77	\$13,326.10
1948	35,419.36	30,892.36
1949	8,074.79	7,267.31

### (3) *Creed credit allowance*

As noted above, between December 1945 and March 1946, the taxpayer performed plumbing work for Y. L. Creed, a general contractor, on several houses. Creed paid a total of \$2,922.50 therefor, of which the first payment was paid to the Plumbing Company, in the sum of \$544 on February 5, 1946. The balance of \$2,378.50 was credited to the taxpayer by Creed in June of 1946, at which time Clark purchased a house from him for a total consideration of \$8,500. The balance or credit of \$2,378.50 was not reported on the books of the corporation, or on the income tax returns of either the corporation or the taxpayers for any of the years in question. There is no evidence that Koyl received any benefit from this credit. In reconstructing corporate income for fiscal 1947, the revenue agent included as an unreported balance due from Creed the amount of \$3,058.50. The amount of \$3,058.50 was not income of the corporation, and was eliminated from corporate income by the Tax Court. (R. 91.) The credit of \$2,378.50 was income to Clark and his wife on the community property basis and one-half of that amount was attributed to Clark for 1946. (R. 76-77.)

### (4) *Truman Johnson credit allowance*

During 1946 Gene Clark, Inc., purchased a house from Truman Johnson, a customer of the corporation, for a

total price of \$22,000, and received a credit allowance of \$6,000 on the purchase price. The \$6,000 credit was not recorded on the books of Gene Clark, Inc., or reported on the corporate income tax returns for any year involved herein. (R. 77.)

#### (5) *“Notes Receivable—Officers”*

As aforementioned, during the entire period in question the two officer-stockholders of the corporation maintained individual open accounts on the corporate books in the “Notes Receivable - Officers” account, to which extensive withdrawals were charged and partial repayments were credited. (R. 77.)

The net withdrawals in the amount of \$36,149.29 from Gene Clark, Inc., as of May 1, 1947, constituted, in reality, disguised dividend distributions rather than loans to the officers during the taxable years involved herein. (R. 77.)

#### (6) *Income—deferred sales*

During each of the taxable years in question the corporation entered into contracts with building contractors for the installation of plumbing and received a percentage of the total contract price as the work progressed. When the rough plumbing was installed, the corporation collected 80 per cent of the total contract price from the contractors, of which 30 per cent was carried on the corporate books as deferred income until the contract was completed. (R. 77-78.)

In a schedule attached to its federal income tax return for fiscal 1947, the corporation explained the account as follows (R. 78-79):

#### DEFERRED INCOME-ADVANCE ON CONTRACT SALES:

This account is based on plumbing contracts not completed. On the installation of rough plumbing, fifty per cent of full contract price is set up as income, in as much as half of the contract terms have been completed. However, after installation of rough

plumbing, eighty per cent of full contract price is collected from customer as per terms of the contract. (50% complete—80% collected). This additional thirty per cent collected from the customer at this period of the contract is carried on the books of Gene Clark Incorporated as deferred income until the contract has been completed. After the installation of finish plumbing has been completed, the remaining fifty per cent of contract price is set up as income and the remaining twenty per cent of contract price is collected from customer. This procedure of accounting has been consistently maintained by Gene Clark Incorporated in order not to overstate income in relation to cost of sales of each contract. At the installation of rough plumbing, it is established that the cost of the contract at this period, consisting mainly of labor, is on the average, fifty per cent of contract cost. Whereas, the cost of the contract on installation of finish plumbing consist mainly of materials, also established to be on the average fifty per cent of contract cost.

The so-called deferred income for fiscal 1947 disclosed in the return, but not included in gross income, was in the amount of \$49,210.15. The revenue agent included the amount in adjustments to corporate income for fiscal 1947 but excluded it from earnings available for distribution in that year, and included it in available earnings for fiscal 1948. (R. 79.)

#### (7) *Pacific Pump, Inc.*

During fiscal 1948, Gene Clark, Inc., received a check from Pacific Pump, Inc., (of which E. J. Weiss was president) for plumbing supplies in the amount of \$1,094.52. The check was included in corporate sales for 1948, but was improperly designated in the journal ledger as having been received from E. J. Weiss. In reconstructing corporate income for fiscal 1948, the revenue agent erroneously included the check as an unreported sale to Pacific Pump, Inc. (R. 79.)

**(8) *Bad debts***

On its tax return for fiscal year 1947, the corporation deducted as bad debts the sum of \$4,874.51 from its gross income. Of this amount, \$3,703.50 was disallowed in fiscal 1947 (no identifiable event establishing worthlessness having been proved by the corporation), and was included as "disallowed bad debts" in adjustments to corporate income for that year. The same sum of \$3,703.50 was then deducted by the revenue agent from total corporate net income available for distribution during fiscal 1947, on the theory that said amount was not actually available for distribution as dividends for that year. During fiscal year 1948, the corporation recovered \$3,216.90 of the above bad debt, and reported this amount on its return. In view of the disallowance of \$3,703.50 as a bad debt deduction for fiscal 1947, the amount recovered (\$3,216.90), together with bad debt deductions allowed by the revenue agent for fiscal year 1948 in the amount of \$1,569.40 (the total of the two items being \$4,786.30), was excluded from net income for fiscal 1948 as "nontaxable income and additional deductions." The amount of \$4,786.30 was then added back to corporate earnings available for distribution during fiscal year 1948. (R. 79-80.)

**Facts Relating to Farm  
Expenditures for 1946 and 1947**

In July 1946, after the corporate directors decided not to purchase North Farm, Clark purchased the farm for himself and planted some 300 acres of wheat thereon, which was expected to mature in the spring of 1947. His father, Clyde R. Clark, managed the farm for the taxpayers. Because of flood conditions in the area which destroyed the crop, there was no income from the farm operations in 1946 and 1947. No deductions for farm losses incident to the operations of North Farm were claimed on the taxpayers' individual tax returns for 1946 and 1947. (R. 80.)

The corporation maintained a special account in the Citizens National Bank of Los Angeles (Maywood), Cali-



fornia, in the amount of \$5,000 (which was set up on the corporate books on December 31, 1946, as an account receivable from the taxpayer), and which was used by the taxpayer's father in Kansas to pay certain operating expenses of the North Farm owned by Clark and also the South Farm owned by Koyl. (R. 80-81.)

During 1946 the following checks were drawn on Gene Clark, Inc.'s "Special Account No. 1" and signed by Clyde R. Clark (R. 81):

<u>Date</u>	<u>Amount</u>	<u>Payable to</u>	<u>Item</u>
Oct. 17, 1946	\$274.95	J. W. Griffith	Seed wheat—North Farm
Oct. 17, 1946	102.15	Lewis Griffith	Seed wheat
Nov. 2, 1946	21.00	North End Service Station	Gas and oil
Nov. 9, 1946	195.57	W. A. Thompson	Seed wheat and oats— South Farm
Dec. 6, 1946	590.36	A. M. Eckelberry Co.	Taxes on both farms
Dec. 6, 1946	36.50	Clyde R. Clark	Repairing fences on South Farm

In addition to the above expenditures, between November 8, 1946, and December 13, 1946, salary checks in the total amount of \$950 were drawn on the special account payable to Clyde R. Clark. (R. 81.)

Of the foregoing items, the Tax Court found that the following were ordinary and necessary business expenses of operation of the North Farm for 1946 (R. 81):

Seed wheat	\$274.95
Taxes	223.24
Salary	475.00
	<hr/>
Total—1946	\$973.19

During the calendar year 1947, Clyde R. Clark drew \$85 from the special account payable to E. Pincher for overhauling a truck. The check does not show that it was for the North Farm. Clyde R. Clark also drew \$200 as

salary from the special account in 1947. On December 3, 1947, Gene paid taxes on his North Farm in the amount of \$223.24. For the calendar year 1947, the Tax Court found the following were ordinary and necessary business expenses for the operation of North Farm: Salary \$100; taxes \$223.24 (R. 82.)

The parties stipulated that the taxpayers sustained losses on their farm operations in Kansas during the taxable years 1948 and 1949 in the amounts of \$17,233.05 and \$17,060.52, respectively, and that such losses were to be reflected in the Rule 50 computation. (R. 82.)

### **Adjusted Basis—Partial Liquidating Dividend**

In his statutory notice for 1948, the Commissioner determined that the taxpayer received a partial liquidating dividend from Gene Clark, Inc., in the amount of \$65,095.94 during that year. The Tax Court adjusted this amount. Initially, the Commissioner determined that the adjusted basis of the taxpayer's 522 shares of stock in the corporation was \$52,100. The parties, however, stipulated that the basis of the taxpayer's 522 shares was \$61,214.49. (R. 82.)

### **Ultimate Findings—Limitations and Fraud**

With respect to calendar years 1945 through 1949, inclusive, the statutory notice was mailed to the taxpayers on February 20, 1953. No agreement extending the statute of limitations on assessment or collection was entered into between the parties for the taxable years 1945, 1946, or 1947. With reference to the taxable years 1948 and 1949, the parties have stipulated that the statute of limitations is not an issue. (R. 82-83.)

Each of the returns of Gene Clark for the years 1946 and 1947 was false and fraudulent with intent to evade tax within the meaning of Section 276(a) of the Internal Revenue Code of 1939. A part of the deficiency of Gene Clark for each of the years 1946 and 1947 was due to

fraud with intent to evade tax within the meaning of Section 293(b). (R. 83.)

Faye Clark filed her individual federal income tax return for the calendar year 1946 on March 15, 1947, reporting thereon gross income in the amount of \$14,651.66. She filed her return for the taxable year 1947 on March 15, 1948, and reported gross income in the amount of \$9,130.51. The notice of deficiency for the years 1946 and 1947 was mailed to her on February 20, 1953. The Commissioner concedes that her returns for 1946 and 1947 were not false or fraudulent with intent to evade taxes. (R. 83.)

Faye Clark omitted from gross income in her return for 1947 an amount properly includible therein which is in excess of 25 per cent of the amount of gross income stated in her 1947 return. (R. 83.)

### SUMMARY OF ARGUMENT

The Tax Court did not err, under the entire record, in sustaining: (a) Both income tax deficiencies (as adjusted) and civil fraud penalties assessed against Gene Clark for his calendar years, 1946 and 1947; and (b) an income tax deficiency assessed against Faye Clark, Gene's wife, for her calendar year, 1947. Incident to the latter holding, the Tax Court correctly determined that, within the meaning of Section 275(c) of the Internal Revenue Code of 1939, the statute of limitations was not a bar against the valid assessment and collection of the wife's deficiency.

The issues presented are essentially factual and each turns, in the final analysis, on the burden of proof. Under well settled principles, in view of the presumption of correctness attaching to the Commissioner's deficiency assessments, the burden was on the taxpayers to adduce affirmative evidence to prove error in the deficiencies, as assessed and as sustained. Under the entire record, it is altogether clear that the Tax Court did not err in holding that the taxpayers failed utterly to sustain their acknowledged burden and that the deficiencies, as finally determined, should here be affirmed. With respect to the

Section 293(b) fraud penalties assessed against Gene for his calendar years, 1946 and 1947, the burden is on the Commissioner to prove, by clear and convincing evidence, that at least part of the deficiency for each year was due to fraud with intent to evade tax. Here, both the entire record and the specific fraudulent transactions selected by the Tax Court for analysis, as pertaining to calendar year 1946 and calendar year 1947, furnish compellingly clear and convincing proof that the Commissioner adduced more than ample affirmative evidence to sustain his burden. In view of such fraud, no statute of limitations bar, of course, attaches to Gene's deficiency assessments against his calendar years 1946 and 1947. However, with respect to Faye's calendar 1947 deficiency, the notice of deficiency was mailed more than three years but less than five years after the individual return for that year was filed. Accordingly, since the Commissioner, in his answer to the petition, pleaded the validity of the assessment within the five-year statute of limitations provided in Section 275(c) of the 1939 Code, the burden was on the Commissioner to adduce affirmative evidence and prove that Faye omitted properly includible amounts from gross income in her calendar 1947 return, which were in excess of 25 per centum of the amount of gross income stated in such return. Since Faye had filed her 1947 return on a community property basis, she was, of course, liable, deficiency-wise, for one-half of all of the additional income attributable to Gene, as constructive dividends from his controlled corporation, Gene Clark, Inc., for the calendar year, 1947. As indicated above, in proving the fraud attaching to Gene's return for this year, the Commissioner adduced affirmative proof of specific fraudulent transactions during that year which gave rise to at least part of the deficiency assessment. One-half of the additional gross income arising on the specific fraudulent transactions affirmatively proved in support of the Commissioner's burden on the fraud issue was reportable by Faye and included in her calendar 1947 deficiency. This amount, which had been omitted from



Faye's 1947 returns, exceeded 25 per cent of the gross income reported in that return. Accordingly, the Tax Court was correct in holding that Section 275(c) was no bar to the assessment and collection of Faye's calendar 1947 deficiency. Were it not for his fraud, which renders the limitations issue irrelevant to Gene's calendar 1947 deficiency, the same rationale would be clearly applicable to sustain his deficiency for that year.

There is no merit in the taxpayer's various contentions raised against the correctness of the Tax Court's decision. The deficiencies were based in their entirety on constructive dividends determined to have been attributable to Clark on the basis of his 70 per cent controlling stock interest in Gene Clark, Inc., a contract plumbing concern, for its fiscal years ended April 30, 1947, and 1948. Clark was the dominant executive in the corporation and controlled its entire method of operations, including the taking of inventories and the decision as to whether certain sales transactions and the proceeds thereof should be entered by the comptroller on the corporation's books. Under the *modus operandi* maintained throughout the period under review certain identifiable transactions with customers, involving substantial amounts, were unreported on the books and the corporate income arising on such transactions was neither reported on the corporate returns or on the taxpayers' returns. Such unrecorded and unreported transactions included both sales to customers for services performed and sales of materials from inventory, sometimes at overceiling prices. Inventory records were so inadequate as to be all but worthless for purposes of computing income incident to material sales. Substantial amounts of corporate funds were expended to purchase Kansas farms for the corporation's two stockholders, Clark and Koyl. Such diversions of funds were carried on the books as "Notes Receivable—Officers", which the Tax Court held, under all the pertinent facts, were dividends and not loans.

An admitted check substitution practice was followed by the corporation with respect to various customers' ac-

counts throughout the period. Under such practice, Clark directed the bookkeeper to turn certain sales invoices and the cash proceeds of various transactions over to him. The cash proceeds of certain unreported sales would then be included in weekly deposits offsetting, total-wise, the earlier received but undeposited proceeds of recorded sales. Such diversions were claimed by Clark to have been used to make over-ceiling purchases of materials. However, no records of such purchases were available, no evidence other than Clark's self-serving assertions was introduced, and Clark admitted the substituted check practice was his idea, that it prevailed throughout the period, and that he had no records of the inventory purchased or sold, or of the profits admittedly made on over-ceiling material sales and incident to trading transactions with other dealers in supplies. In all but one minor instance, the unreported and unrecorded additional income items (including check substitutions) identified by the agent were either stipulated or uncontested. Expense deduction disallowances were likewise uncontested as additional income items. Since the check substitution practice involved omission to record covering sales invoices on the sales register, thus producing a reconciliation, as to total recorded amounts, in the cash receipts, sales to customers, bank deposits, and sales, per the tax returns, identification of the transactions giving rise to the additional corporate income was achieved through use of the bank deposits method, entailing a detailed matching of items recorded in cash receipts, sales invoices, and bank deposit slips. The questioned transactions were thus identified as non-matching items, *vis-a-vis*, individual sales and the sales proceeds deposited. Affirmative evidence of the questioned transactions was adduced by the Commissioner by calling various participating third-party customers as witnesses. The correctness of the Commissioner's proof as to these additional income items was confirmed both by Clark's admissions and by the taxpayer's stipulations to that effect. No affirmative evidence to the contrary was produced by the taxpayers. Their only non-party

witness, Claypoole, had no knowledge of either the books or records or of the transaction details.

The revenue agent allocated the additional corporate income to Clark for both fiscal years on a stock ownership basis and further allocated the resulting amount to both spouses' calendar years involved, determining that Clark's community share in the fiscal 1947 constructive dividend for calendar year 1946 was \$22,113.56, based on a total corporate distribution for fiscal 1947 of \$79,448.72. In arriving at the total distribution figure, the agent made various adjustments to corporate earnings and profits. For the calendar year, 1948, the agent determined each spouse's allocable additional taxable income to be \$24,750.49, based on total corporate distributions of \$149,233.83. The Revenue Agent's Report supplied the basis for determination. But, as the Tax Court's opinion correctly shows, certain adjustments, both for and against the taxpayer, were necessary in order to arrive at a correct determination of the deficiencies resulting from the clearly indicated and substantially admitted corporate constructive dividends for fiscal 1947 and 1948. Taxpayers' attack on the allocation of the distributed corporate income is without basis. As taxpayers filed returns on a calendar year basis, while the corporation reported on a fiscal year basis ending April 30th, and as it was impossible to determine from the records the actual dates upon which Clark took to his own use cash belonging to the corporation, some allocation was necessary to place the withdrawals from the corporation into taxpayers' proper calendar years. In addition, it was necessary to determine the corporate earnings and profits for each of its fiscal years in order to determine what portion of the withdrawals represented constructive dividends and what portion, if any, represented withdrawals of capital. Taxpayers attack the allocation of the withdrawals from the corporation's fiscal year ending in 1947: 70% of 84.259% thereof as taxpayers' share of the corporation's available earnings to their calendar year 1946, and 70% of 15.741% thereof as income falling within their calendar year 1947.

In this connection the Tax Court, in upholding the allocation, pointed out that the taxpayers, while not admitting any constructive dividends for the period, did not dispute, assuming there were such dividends, an allocation of 70% to Clark and 30% to Koyl according to their proportionate stock interests; that taxpayers had failed to establish that their share, \$44,227.13, was actually less (or greater) than the amount determined. They merely pointed to the fact that only two-thirds of the company's fiscal year was in 1946. The Tax Court then stated that it found no basis for holding that the allocation was arbitrary. That taxpayers made no motion to require the respondent "to file a further and better statement" (Tax Court Rules of Practice, Rule 17(c)(1)), as a basis for challenging the allocation. Taxpayers cited no authorities or reasons to support their theory that the allocation, to be rational, must in this case be proportionate to the number of months of the corporation's fiscal year which falls in the taxpayers' calendar year. The Tax Court then pointed out that the withdrawals from "Notes Receivable—Officers" account, which it held to be dividends, reached the substantial net amount of \$34,557.46 as of December 31, 1946, and increased only \$1,591.83 between that date and April 30, 1947, the end of the corporation's fiscal year. It followed with the statement that the burden is on the petitioner, the record offers some affirmative support for respondent's action in weighing the particular allocation by attributing the larger percentage to 1946, hence petitioner had failed to prove that the allocation was erroneous or arbitrary, and that there was no basis for holding it invalid, citing this Court's decision in *Greenwood v. Commissioner*, 134 F. 2d 915. (R. 106-107.)

The Tax Court then stated that the above relating to 1946 made it apparent that taxpayers' understatement in their 1947 calendar year return of constructive dividends for the fiscal year 1947 was that which it computed—\$8,262.34.

Taxpayers also attack (Br. 9) the percentage of the income of the corporation for the fiscal year ending in



1948 allocated to taxpayers' calendar year 1947. In this connection the Tax Court made adjustments to the amount available for distribution as shown by the Revenue Agent's Report, stating its reasons therefor (R. 110-122). It then stated that other than the adjustments it had made the taxpayers had failed to meet their burden of proving error in the respondent's determination. Accordingly, it accepted its figure of \$85,827.47 as representing total distributions from the corporation for the year 1948. It then held that ~~\$54,028.91~~ was the amount of earnings available for distribution as ordinary dividends and that the balance was to be treated as a liquidating dividend. Hence, as the law treats any distribution as distribution of earnings and profits to the extent available, it upheld the Commissioner's allocation on the ground that Clark's share of available earnings amounted to only \$31,520.44; and that on any appropriate basis of allocation of distributions (\$85,827.47) from the corporation's fiscal years 1948 to the taxpayers' calendar year 1947 (which included eight months of the corporate fiscal year 1948), the distributions attributable to taxpayers for 1947 would be at least sufficient to encompass the amount allocated to them. (R. 123-124.)

Affirmative evidence of Clark's "badges of fraud" pervades the entire record. Specific instances of fraud, showing that at least part of each calendar year's deficiency was due to fraud with intent to evade tax were clearly and convincingly proved by the Commissioner. The statute of limitations is no bar as to Faye Clark. The decisions of the Tax Court should here be affirmed.

## ARGUMENT

**The Tax Court Did Not Err, Under The Entire Record Here Presented, In Sustaining (a) Both Income Tax Deficiencies And Civil Fraud Penalties Assessed Against Gene Clark For His Calendar Years, 1946 And 1947; And (b) An Income Tax Deficiency Assessed against Faye Clark For Her Calendar Year, 1947**

We submit that, under this entire record, the Tax Court's decision (R. 160, 161) entered against both taxpayers, Gene and Faye Clark, should here be affirmed. Specifically, we submit that taxpayers have failed to sustain their burden of proving error in the deficiencies assessed (to the extent sustained below, for both years) and that the Commissioner has clearly and convincingly carried his burden of proving that some part of Gene Clark's respective deficiencies assessed for his calendar years, 1946 and 1947, was due to fraud with intent to evade tax, within the meaning of Section 293(b) of the Internal Revenue Code of 1939. (Appendix, *infra*.) Moreover, we submit that the record herein, viewed in its entirety, furnishes cumulatively compelling support for the Tax Court's findings and conclusions with respect to each and every branch of the composite federal income tax issue raised in this petition for review. Finally, we submit that there is no merit in any of the contentions (Br. 8-33) herein raised by the taxpayers.

Essentially this is a factual case, turning ultimately, in each of its branches, on the trial court's appraisal of the evidence in the light of the respective burdens borne by the responsible parties. The applicable law is well-established. Boiled down to its essentials, the case is basically simple, in that there is a conspicuous absence of affirmative taxpayer evidence which can serve to dispel, in any degree, the presumption of correctness attaching to the Commissioner's assertion of the deficiencies and an overabundance of affirmative Government evidence clearly and convincingly supporting the trial court's finding (R. 83) and conclusion (R. 136, 140, 142) that Gene Clark filed his

calendar years 1946 and 1947 returns with fraudulent intent to evade tax. After meticulously setting out his detailed findings (R. 52-83), the Tax Court judge, below, has painstakingly and authoritatively spelled out his reasoning with respect to both the deficiencies (R. 83-125; 142-145) and the fraud (R. 134-142) here in issue on both an over-all and on an item-for-item basis and has concluded against the taxpayers on both counts. We agree with the Tax Court's conclusions, the basic underlying reasoning, and the applicability of the authorities cited therefore, and respectfully invite the attention of the Court to the detailed transactional analysis therein set forth. While adopting it, in the light of the entire record, as our own, we shall not attempt an extended repetition of the reasoning here but, instead, shall confine our brief to an answer to the specific contentions (Br. 8-33) made by the taxpayers to this Court.

***A. The Tax Court did not err in its determination of the deficiencies***

There is no merit in the taxpayers' contentions (Br. 8-28) that the Tax Court's findings (R. 58-80) and conclusions (R. 83-125) with respect to the 1946 and 1947 calendar year deficiencies were erroneous. These contentions, singly and collectively, are demonstrably groundless.

In alleging error in the deficiencies, the taxpayers: (a) Chose (throughout their entire argument) to ignore both their affirmative burden of proving error in the deficiency assessments and their patent failure to sustain that burden; and (b) attempt (Br. 11, 17-20, 23-26, Appendix 2-9) to ignore the true significance of the facts, as developed in the record, and to ascribe a significance to the findings which simply does not here obtain.

Essentially, the correctness of the Tax Court's conclusions below finds more than ample support in the record. All of the deficiencies here in issue, represented constructive dividends from Gene Clark, Inc., the corporation, arising by reason of its plumbing business transacted during its first two fiscal years ended April 30, 1947, and 1948.

Clark was the 70 per cent controlling stockholder of the corporation; his associate, Koyl, owned the remaining 30 per cent stock interest. Faye Clark's interest, as a taxpayer, springs from the fact that she and her husband reported their income for calendar years 1946 and 1947 as a community property basis, filing separate returns for those years.

The Commissioner's determination of a deficiency is presumptively correct. *Helvering v. Nat. Grocery Co.*, 304 U.S. 282; *Helvering v. Taylor*, 293 U.S. 507; *Goe v. Commissioner*, 198 F. 2d 851 (C.A. 3d), certiorari denied, 344 U.S. 897; *Snell Isle, Inc. v. Commissioner*, 90 F. 2d 481 (C.A. 5th), certiorari denied, 302 U.S. 734. The burden of proof rests with the taxpayer to establish error in the Commissioner's determination of deficiencies by at least a preponderance of the evidence. *Helvering v. Taylor*, *supra*; *American Pipe & Steel Corp. v. Commissioner*, 243 F. 2d 125 (C.A. 9th); *Greenwood v. Commissioner*, 134 F. 2d 915 (C.A. 9th). On factual issues, such as are presently presented, the Tax Court's determination should not properly be disturbed on review unless clearly erroneous. Here, the Tax Court based its several determinations, in part, upon its appraisal of the credibility of witnesses, including taxpayer Clark, who testified before it. Upon review, due regard is properly accorded this opportunity possessed by the trial court. *United States v. Gypsum Co.*, 333 U.S. 364, rehearing denied, 333 U.S. 869; *Staudt v. Commissioner*, 216 F. 2d 610 (C.A. 4th); *Hague Estate v. Commissioner*, 132 F. 2d 775 (C.A. 2d), certiorari denied, 318 U.S. 787; Rule 52(a), Federal Rules of Civil Procedure; Section 7482(a) of the Internal Revenue Code of 1954 (formerly Section 1141(a) of the 1939 Code). In any event, contrary to the taxpayers' contentions (Br. 8-16), the record, here, furnishes ample support for the Tax Court's findings and conclusions with respect to the deficiencies. Neither does any merit attach to the taxpayers' contentions (Br. 8-20), which are at least made implicitly, that the Tax Court's adjustments made to the revenue



agent's deficiency computations, as urged by the Commissioner below, were arbitrary, capricious or erroneous.

Where, as here, the trial court holds (R. 92-93, 107) that the taxpayer has failed to sustain this burden, and, yet, it appears to the trial judge that errors (both for and against the taxpayer) have been made by the agent in the report which gives rise to the deficiency assessment, the law is clear that such errors may be corrected and that, if the circumstances warrant it, the Commissioner may be affirmed for reasons other than those which he, himself, has assigned. *Chiple v. Commissioner*, 25 B.T.A. 1103, 1105-1106; *Gossett v. Commissioner*, 22 B.T.A. 1279, affirmed, 59 F. 2d 365 (C.A. 4th).

In making his examination of the corporation Revenue Agent Phillips, in the absence of accurate books and records, employed the so-called "bank deposit" method (R. 435-517),<sup>4</sup> which uncovered glaring discrepancies, item

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<sup>4</sup> The agent analyzed the cash receipts, recorded sales (per the sales journal), and cash deposits in the corporate bank account, with individually recorded cash receipts being matched against individually recorded cash sales for purposes of item identification and individually recorded cash sales, item-wise, being matched against cash deposit items included on the bank deposit slips. Such detailed matching procedure revealed the existence of a cash substitution practice consistently employed by the corporation throughout the fiscal years 1947 and 1948 here involved, and other unrecorded and unreported transactions whereby substantial amounts of cash sales receipts and other property were siphoned off by both Clark and Koyl, the sole stockholders.

The Tax Court found (R. 59-63) that this intentionally followed practice, which was *one* key to the corporation's patent failure to keep accurate books and records, was implemented by the fact that Clark had direct control over the corporate activities, including the corporate records and the disposition of cash receipts. At his direction, certain undeposited cash receipts were turned over to him personally, with the sales giving rise thereto being recorded. The customary practice of making bank deposits on a weekly basis thus permitted the subsequent inclusion of total weekly deposits of the covering cash proceeds of substituted sales which were never recorded or reported on the books or the tax returns. As a result, the *total* deposits would equal the *total* recorded sales; the non-matching recorded but undeposited sales and subsequently deposited *substituted* sales proceeds, per the bank deposit slips, however, reflected, item-wise, amounts of corporate cash diverted by Clark.

wise (R. 449-450), between the sales recorded and the sales proceeds included on the bank deposit slips. The amounts so disclosed as never having been recorded on the corporate books were, in many instances, identifiable, transaction-wise by fiscal year (Findings of Fact, R. 63-73) and, dollar-wise were substantial, constituting the basis for the asserted deficiencies. Contrary to the attempted inference which the taxpayers seek to draw (Br. 11), the fact that total recorded sales, per the books, reconciled with sales reported on the corporation returns amounts, in substance, to a tacit admission that the identical substantial amounts of unrecorded sales proceeds which never were entered on the books were similarly unreported on the tax returns. Moreover, it is a distinction without a difference to argue (Br. 11) that the substituted checks were all recorded, since it is the recording of cash proceeds from unreported sales which furnishes the offsetting entry, accounting-wise, to replace the cash proceeds of earlier reported sales which have been appropriated to the stockholders' avail. Actually, under the facts here obtaining, the establishment of a consistently followed pattern of unrecorded transactions and check substitutions reflecting substantial understatements of income (albeit in undetermined amounts) serves to render the corporation's books and records worthless for purposes of accurately determining income. In such circumstances, as the Tax Court carefully pointed out (R. 86-87), the Commissioner was properly entitled to resort to some reasonably effective method for determining the net income. Under the circumstances here obtaining, absent reliable records and present a pattern of purposeful concealment, the Tax Court was entirely justified in holding, contrary to the taxpayers' contention (Br. 8-10), that the method adopted—*viz.*, bank deposit analysis with allocation of additionally developed corporate income on the basis of stock ownership and further allocation to individual calendar years—reached a result that cannot here be viewed as arbitrary. *Helvering v. Taylor, supra*;

*Chesbro v. Commissioner*, 21 T.C. 123, 128, affirmed, 225 F. 2d 674 (C.A. 2d), certiorari denied, 350 U.S. 995.

Moreover, the very fact that the "bank deposit" analysis, with allocations, was, here, the only practical and reasonable method available to the Commissioner for purposes of arriving at the asserted deficiencies serves to highlight the lack of merit in the taxpayers' complaint (Br. 13) that no net worth analysis was made. Since the deficiencies here in issue are derivative in the sense that they originate in the corporation it is obvious that the constructive dividends here computed have an independent existence apart from the net worth position of the recipient. Assertion of the amount thus constructively received, coupled with the taxpayers' failure to carry their burden of proving error, is sufficient to sustain the deficiencies so derived. In such a case, the effect of the receipt on the net worth of the stockholder is patently irrelevant.

Acknowledging their burden of proof with respect to the deficiencies (Br. 14), the taxpayers attempt to argue (Br. 14-16) that they have carried their burden. Nothing could be further from the facts. As we have pointed out above the deficiencies were derived essentially from corporate constructive dividends which, in turn, were substantially computed as a result of adding the proceeds of certain identified unreported sales (including substituted items) to fiscal 1947 and 1948 net income. Included also in the revenue agent's computation were a few adjustments representing expense disallowances. Proceeding from the computation in the revenue agent's report, the taxpayers' contentions made at the trial against the presumed correctness of the deficiencies were chiefly raised on a transaction-by-transaction basis, with only selected items of asserted additional corporate income being contested.

There is clearly no merit in taxpayers' reliance (Br. 14, 18) on the so-called "expert" testimony of Witness Paris B. Claypoole and on the allegedly "corroborated" testimony of Gene Clark (Br. 16). This was the principal affirmative testimony adduced by the taxpayers which is

available to them for purposes of sustaining their burden of proving error in the deficiencies. Far from establishing error, this testimony serves in large part to buttress the case for the presumed validity of the assessments. Claypoole, on direct testimony (R. 179-208), did little more than identify certain of the contested items in the revenue agent's report and state the treatment accorded such items by the agent. With respect to the disputed Truman Johnson item of \$6,000 he was of the erroneous opinion (R. 194) that a corporate owned house could not be treated as distributable simply because it was a non-cash asset. With respect to the disputed deferred income item of \$49,210.15, he conceded (R. 195) that the amount might have been paid in in cash, but expressed the opinion that it would not be distributable in 1946 simply because the plumbing on which it had been paid had not been completed in that year. He knew little or nothing (R. 194, 195) about the facts underlying the disputed H. L. Brittain and Bad Debt eliminations made by the agent from distributable fiscal 1947 earnings. He testified (R. 195-196) to the correctness of not including *reported* fiscal 1947 taxable income of \$30,632.10 in distributable earnings for that year. With respect to allocation of the corporation's fiscal 1947 distributable earnings to a stockholder's 1946 calendar year, he expressed the patently erroneous opinion (R. 203-204) that no constructive dividend from fiscal 1947 could be so allocated because it would not be known, during calendar year, 1946, whether there would be any fiscal 1947 earnings available at the year's end.

Claypoole's testimony is not only self-contradictory but serves to underscore taxpayers' failure to sustain their burden of proving error in the deficiencies. When questioned by the trial judge as to his opinion respecting the availability of earnings for distribution in dividends prior to the corporate year's end, he reversed himself and admitted (R. 207) that the only criterion is that there be such available earnings and profits at the conclusion of the first taxable year in order to treat a prior distribu-



tion as an ordinary dividend for tax purposes. On cross examination (R. 208-213), he admitted (R. 208) he had never examined the corporation's books and records, had never demanded (R. 211-212) that he be shown such books, and was testifying (R. 208) only on the basis of an examination of the revenue agent's report and the tax returns. He admitted further (R. 211) that he was not in a position to say whether there had been any actual distributions to the stockholders which were not reflected on the books and records.

With respect to his earlier expressed opinion (R. 195-196) that the fiscal 1947 reported taxable income of \$30,-632.10 was not properly available for distribution, Claypoole reversed himself and admitted (R. 208-211) that the fact that such earnings might be in the form of machinery or equipment or other property would not prevent the amount thereof to be treated as distributable earnings. In short, Claypoole's testimony, viewed in its entirety, not only does not even tend to aid the taxpayers in support of their acknowledged burden of proof but, instead, all but flatly admits the Commissioner's contention and the Tax Court's determination with respect to the availability of sufficient earnings and profits to support constructive dividend treatment of the deficiencies, as finally determined below. It also stands as a concession of the validity of the Tax Court's basic reasoning underlying its inclusion (R. 94-97) of the five disputed items, totaling \$63,488.47, in earnings and profits available for distribution in fiscal 1947.

Proceeding to Gene Clark's testimony (R. 315-394), the conclusion is inescapable that, far from contributing any affirmative support to carrying the taxpayers' burden of proving error in the deficiencies, the effect of this testimony was to shore up the case for their validity, as finally determined. While alleging, on direct examination (R. 315-353), that he used appropriated corporate cash to purchase plumbing supplies at over-ceiling prices, Clark admitted (R. 331) that Files, his bookkeeper, did not know of the amounts which were so expended. He admitted



(R. 330) that he no longer possessed a record which he claimed to have kept on such transactions. He admitted further (R. 332) that he personally took the opening inventory for the corporation and that he had no records (R. 331-332) of the sale of materials from inventory. Additional admissions dealt with: (a) The intermingling (R. 332) of alleged separate inventories of the corporation and its predecessor, Clark Plumbing; (b) the fact (R. 333-334) that alleged trading transactions were unrecorded; (c) the receipt of an unrecorded \$12,000 in cash (R. 336-337) pursuant to an unrecorded sale of plumbing materials; (d) the purchase in his own name and that of his wife, of two Kansas farms (R. 344-346) with corporate funds, in 1946; (e) the existence of a "Notes Receivable—Officers" account on the corporation's books (R. 346) reflecting an indebtedness of his to the corporation in the amount of \$27,518.99,<sup>5</sup> with the account name (R. 349) later being changed to "Trust Deeds"; (f) the fact (R. 349) that the corporation never owned any trust deeds; and (g) the receipt (R. 351) of a \$20,000 dividend from the corporation which reduced his indebtedness to \$27,518.99.

On cross-examination (R. 353-385), Clark admitted further that: (a) Over-ceiling sales (R. 361-362) at a profit were not included in his income tax returns throughout the period; (b) no books (R. 364) were kept for Clark Plumbing, although he knew a profit was realized on sale of materials attributable thereto; (c) he understood (R. 364-368) the substituted items practice, which was his idea

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<sup>5</sup> The Tax Court found that on May 1, 1947, the net withdrawals from the corporation, as recorded in the "Notes Receivable—Officers" account, were \$36,149.29. (R. 77.) As of December 31, 1946, the net withdrawals in the account amounted to \$34,557.46. (R. 107.) In computing the total corporate constructive dividend for fiscal year 1947, the agent included the \$36,149.29 in additionally determined gross income. (R. 105.) The Tax Court (R. 102-105) held that this \$36,149.29 did constitute dividends and not loans, but, in correcting the corporation's fiscal 1947 distributable income, expressly excluded the item from both income and earnings and profits (R. 105). It stands, however, as one admitted diversionary channel which served to absorb appropriated corporate cash during Clark's calendar year, 1946.

and resulted in sales not being recorded on either the books or the corporate tax returns; (d) he did not account (R. 367) for the profits on substituted item transactions; (e) he understood the difficulty (R. 368) attending examination of unrecorded transactions; (f) while he allegedly kept a pocket book on his material sales (R. 370-371) he never used it for purposes of computing profits and never showed it to Files, his bookkeeper; (g) he instructed Files (R. 374) to turn over all cash to himself; and (h) he gave no note to the corporation (R. 385) when he acquired money to purchase the farms in 1946.

Not only do the taxpayers fail utterly to adduce any persuasive evidence in support of their acknowledged burden of proving error in the deficiencies, as demonstrated above, but, in addition, they have stipulated, at the trial, to the vast majority of the specifically indicated unrecorded transactions (including substituted items) which constituted the substantial basis for the constructive dividends developed, computation-wise, in the revenue agent's report. At the trial, the taxpayers, for all practical purposes, accepted the revenue agent's report as the general backdrop for the deficiencies and concentrated their efforts on contesting specific items which the agent had added to corporate income for fiscal years 1947 and 1948. The proof pattern was a relatively simple one. In connection with the Section 293(b) civil fraud penalty assessments, discussed in Part B, *infra*, it was incumbent on the Commissioner to introduce affirmative evidence in support of his burden of proof on that issue. Accordingly, he introduced the testimony of various third party customers of the corporation who could testify (R. 213-240) to particular transactions and also called Clark's bookkeeper, Frederick W. Files (R. 240-287), who testified to the corporation's practices followed with respect to the keeping of books and records, and Revenue Agent Phillips (R. 287-315),<sup>6</sup> who testified with respect to the prepara-

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<sup>6</sup> By stipulation (R. 176) the testimony of Revenue Agent Phillips in the companion cases of *Archie M. Koyl, et al. v. Commissioner*, T.C. Docket Nos. 48336, 48337 and 48338, has been made part of the record in this case (R. 435-517).

tion of his report and the inclusion of additional income items in corporate income for fiscal 1947 and 1948. Incident to such testimony by the Commissioner's witnesses, the taxpayers' counsel either allowed the items to stand uncontested or stipulated, in open court, to the agent's income treatment accorded each,<sup>7</sup> the one exception being a check from Pacific Pumps, Inc., in the amount of \$1,094.52 (R. 79, 115), which had been erroneously included by the agent in fiscal 1948 income. On the basis of the foregoing, insofar as the taxpayers' introduction of evidence in support of their burden of proving error

<sup>7</sup> Specific transactions stipulated to below by taxpayers' counsel, or uncontested:

<u>Fiscal Year Ended April 30, 1947</u>	<u>Amount</u>	<u>Record Reference</u>
Truman Johnson	\$ 6,000.00	R. 221-222, 225
Y. L. Creed		
(Credit to Clark: \$2,378.50)	3,058.50	R. 216-218
H. L. Brittain	1,860.40	Uncontested
Ben Lang	1,900.90	"
Substituted Items	14,806.77	"
Deferred Income	49,210.15	"
Merchandise Purchases		
(deduction disallowed)	2,714.42	"
Bad Debts		
(deduction disallowed)	3,703.50	"
Other Unreported Items	7,123.36	"

Fiscal Year Ended April 30, 1948:

Hamilton Homes, Inc.		
(3 items)	5,686.00	R. 230
H. K. Niles	1,000.00	R. 297-298
So. Cal. Investment Co.	6,670.00	R. 295
Other Substituted Items	20,968.84	Uncontested
Valley Boulevard Plumbing & Elec. Co. (3 items)	38,009.74	R. 295
James M. Young, Jr.	1,902.73	R. 69
Other Unreported Items	21,234.80	Uncontested
Allen T. Mitchell & Son	2,294.50	R. 296
A & F Plumbing & Heating	2,223.76	R. 296
Ben Lang	1,558.44	R. 228
Valley City Supplies Co.	2,731.54	Tr. 94; R. 295
Walter A. Story	1,700.00	Tr. 96
Other Uncontested Items	24,130.99	Uncontested

in the deficiency assessments is concerned, the Commissioner's determination would stand substantially intact, as assessed. Under the revenue agent's computations (R A R, Ex. Q, p. 81) the corporate constructive dividend for fiscal year 1947 was \$74,984.96, with 70 per cent of such amount, or \$52,489.47, being treated as a distribution to the Clarks, \$44,227.13 to their calendar years, 1946, and \$8,262.34 to their calendar years, 1947. This produced a deficiency for Gene Clark for his calendar year, 1946, of \$22,113.56, as assessed on the community property basis. Faye Clark's 1946 calendar year is barred by the statute of limitations and is not here in issue.

As for fiscal year 1948, the corporate constructive dividend, per the agent's report, was \$149,233.83, of which amount the portion of Clark's 70 per cent share (\$106,334.59) allocated to the spouses' calendar year, 1947, was \$43,376.22. Adding thereto the \$8,262.34 carried over to calendar year 1947, from fiscal year 1947, and taking into account a partial liquidating dividend of \$2,137.57 computed by the agent, the total amount of the constructive dividend to the Clarks for calendar year 1947 was \$49,500.99, of which amount the deficiency for each spouse was \$24,750.50, as assessed. (R. 14, 34.)

As we have pointed out above, whereas the taxpayers' unsuccessful attempt to prove error in the assessed deficiencies was directed at the computations set forth in the revenue agent's report, the report itself, being stipulated in evidence for the limited purpose of showing the arithmetic basis for the deficiencies (R. 289, 443), served only as a framework for arriving at the correct amount of the deficiencies. Under the stipulation the report does not stand as evidence of the proof of its contents, so as to foreclose either the Commissioner or the Tax Court with respect to the assignment of, and/or correction of, computation errors included therein. Pleading-wise, the only limitation on the Commissioner as a result of the deficiencies assessed on the basis of the report was that a correction of any detected errors could not serve as the basis for *increasing* the deficiencies assessed. Contrary



to the taxpayers' present contention (Br. 19-20), however, no new matter was here pleaded by the Commissioner, although, by terms of the stipulation (R. 289, 443), he was never bound by the contents of the agent's report, concession-wise, no additional deficiencies over and beyond the original deficiencies were ever pleaded. Accordingly, the taxpayers' burden of proof with respect to their contention of error as to the original deficiencies never shifted from their shoulders.

As both the Commissioner and the Tax Court recognized (R. 93), several inadvertant but readily revisable errors were apparent in the agent's computations; their correction amounted to nothing more than a recapitulation of the facts, as accepted by both the parties, amount-wise, and a computation of the corporate and individual tax consequences flowing from these facts. The fact that the Tax Court, in making this recomputation, was able to utilize certain pertinent computation figures in the revenue agent's report springs from the fact that such amounts—*viz.*, income reported on the fiscal 1947 and 1948 tax returns (R. 59), (fn. 3, *supra*), claimed expense deductions disallowed and distributions to the Clarks, as computed by the revenue agent (R. 92, 122, R A R, Ex. A, p. 81)—constitute uncontested items which have either been stipulated or accepted by the taxpayers by the simple procedure of introducing no evidence whatsoever to the contrary. (Neither was the Tax Court bound, absent any credible affirmative evidence adduced to sustain taxpayers' burden of proving error in the deficiencies, to accept or reject the agent's allocation of the fiscal 1947 constructive dividend to Clark's calendar years, 1946 and 1947.<sup>8</sup>

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<sup>8</sup> The preliminary allocation of the constructive dividends between Clark and Koyl on the basis of stock ownership is, of course, entirely reasonable in view of Clark's dominant position of control and his numerous admissions, set forth above, with respect to his intentional adoption of the substituted cash practice employed by the corporation throughout the period under review.



As the Tax Court pointed out (R. 106-107), no basis was presented for treating the agent's fiscal 1947 allocation as arbitrary. The taxpayers were fully aware of the allocation made and, nevertheless, made no motion under Rule 17(c)(1) of the Tax Court Rules of Practice to require the Commissioner "to file a further and better statement". No authorities or reasons for a different allocation formula were advanced. As indicative justification for the fiscal 1947 allocation of 84.259 per cent of Clark's dividend to his individual calendar year 1946, the trial judge pointed out, "if only for suggestive consideration", that withdrawals from "Notes Receivable—Officers" were reported as \$34,557.46 at December 31, 1946, and increased only \$1,591.83 between that time and April 30, 1947. Taking into account both the taxpayers' utter failure to carry their burden of proof and the existence of such affirmative record support for the weight accorded calendar year 1946 in the agent's allocation, the Tax Court concluded (R. 107), contrary to the taxpayers' contentions (Br. 8-10, 23-25, Exs. A and B, Appendix 1, 2), that they had failed to prove error in the fiscal 1947 constructive dividend allocation.

Moreover, on the factual issue as to whether Clark's allocable portion of the \$36,149.29 "Notes Receivable—Officers" account represented the receipt of additional fiscal 1947 dividends or a true "loan" (*Wilson Bros. & Co. v. Commissioner*, 10 T.C. 251, other issues affirmed, 170 F. 2d 423 (C.A. 9th)), the Tax Court concluded, on balance (R. 102-105) and contrary to the taxpayers' contention raised herein (Br. 27-28), that, apart from corporate formalities and adverse book entries, the surrounding facts and circumstances—*viz.*, withdrawals in proportion to stock ownership, absence of any notes or trust deeds, etc.—indicate an officer-stockholder-director intent that they were dividends (*Baird v. Commissioner*, 25 T.C. 387; *Estate of Simmons v. Commissioner*, 26 T.C. 409).

Despite this buttressing support for the weighted fiscal 1947 allocation, which, if so treated, would increase the constructive dividend from \$79,448.72 (R. 93) to

\$115,598.01, the Tax Court (R. 105) expressly eliminated the \$36,149.29 from both fiscal 1947 additional net income and available earnings. In point of fact the record expressly refutes the taxpayers' implication (Br. 28) that Clark on April 29, 1948, paid \$20,000 out of his own pocket on this account. His bookkeeper, Files, testified (R. 281-282) that, on April 30, 1948, the corporation distributed a \$20,000 cash dividend to Clark, as the then 99 per cent stockholder; that Clark never returned the check to the corporation for credit against his alleged account liability; and that Clark did give Files "other checks" (*viz.*, substituted items) in the amount of \$20,000, which was credited against his "Notes Receivable—Officers" account.

Moreover, contrary to the taxpayers' contention (Br. 19) that the determined constructive dividends were not distributed to Clark, the Tax Court's factually sound conclusion that the \$36,149.29 constituted dividends (R. 104-105) clearly indicates that a substantial portion of the constructive dividend was expended during calendar year 1946, for the farms in Kansas. However, it is pertinent to point out that it is the establishment of the availability of the constructive dividends to the taxpayers' use which is controlling with respect to taxability as income rather than the traceability of the diverted corporate funds into the taxpayers' respective pockets. In other words, Clark's own admissions that he kept the proceeds of recorded but undeposited sales qualifies such diverted proceeds as portions of the taxable constructive dividend, even though the examining agent cannot prove what Clark did with the appropriated cash.

With respect to the corporation's fiscal year 1947, the Tax Court, after careful analysis, determined (R. 93) that the total constructive dividend, after adjustment, was \$79,448.72. Since this amount exceeded the \$74,984.96 figure used by the Commissioner (R A R, Ex. Q, p. 81) as the basis for Clark's fiscal 1947 constructive dividend, the Tax Court, absent any affirmative proof of error advanced by the taxpayers, affirmed Clark's calendar 1946

deficiency assessment, based on the accepted allocation to that year of \$22,113.56 (R. 92-93). Under the allocation of Clark's 70 per cent share of the fiscal 1947 constructive dividend, \$8,262.34 was attributable to the Clarks' calendar year 1947 income on a community property basis. (R. 110.) With respect to the \$4,463.76 excess of available fiscal 1947 earnings, as adjusted, over \$74,984.96, as computed by the agent, the Tax Court expressly held (R. 93-94) that, absent any affirmative pleading or evidence adduced by the Commissioner, no basis existed for carrying such excess over into the corporation's fiscal year 1948.<sup>9</sup>

In arriving at its adjusted fiscal 1947 distribution figure of \$79,448.72, the Tax Court recast, somewhat, the corporate gross income and distributable earnings figures computed by the agent (R A R, Schedule 1, p. 5; Ex. Q., p. 81). Additional gross income of \$138,473.43 (R A R, Ex. Q., p. 81), as computed by the agent, was reduced to \$97,511 by reason of the elimination therefrom of: (a) the Y. L. Creed item of \$3,058.50 (R. 102);<sup>10</sup> (b) \$1,480.67,

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<sup>9</sup> Actually, although the determination is academic for purposes of this appeal, it is submitted that the axiomatic treatment of a corporation's excess earnings and profits accumulated over and beyond the dividend distribution of a given year would be to carry the excess over automatically to the following year as accumulated earnings and profits available for dividend distribution in the later year. In other words, the concept is a basic one, generic to the federal income tax law, and is not dependent for its operative effect on affirmative pleading or the introduction of evidence. Since, here, the corporation's fiscal 1948 earnings and profits, as determined by the Tax Court, were exhausted, with the finally determined deficiency being smaller than the assessment against the Clarks for their calendar year 1947, this \$4,463.76 excess from fiscal 1947 earnings and profits could presumably have been used had the Tax Court held otherwise. However, this issue has not been raised by the Commissioner and is not before this Court on appeal.

<sup>10</sup> This item is discussed, *infra*, in Part B. Under its findings (R. 63-64), the Tax Court held (R. 102) that the credit of \$2,378.50 allowed Clark was income to Clark and his wife for calendar year 1946 (R. 91), with one-half thereof being attributable to Clark, individually. The amount, however, was in excess of the deficiency assessment and, accordingly, was not taken.

representing 10 per cent of fiscal 1947 substituted items (R. 96), allowed as a deduction because of the claimed cashing of accommodation checks (*Cohan v. Commissioner*, 39 F. 2d 540 (C.A. 2d)); (c) other investments of \$273.97 (R. 105-106), included by the agent but excluded by the trial court; and (d) "Notes Receivable—Officers" in the amount of \$36,149.29 (R. 102-105), included by the agent and held to be dividends but not included by the trial court (R. 105). To the \$97,511 was added \$30,632.10 (R. 59), representing reported fiscal 1947 income, which, apparently inadvertantly, had been omitted by the agent from his computation of distributable earnings. [In the Tax Court's computation of fiscal 1947 distributable earnings, \$63,488.47 (which the agent had included in income (RAR, Schedule 1, p. 5) but eliminated, erroneously, from distributable earnings (RAR, Ex. Q, p. 81)) was restored (R. 92).] From the resulting adjusted figure of \$128,-143.10 (which was thus identical both as income and as distributable earnings) a federal tax adjustment of \$48,-694.38 (R. 91) for accrued income taxes was deducted (*Estate of Stein v. Commissioner*, 25 T.C. 940), thus producing an adjusted distributable constructive dividend figure of \$79,448.72 for the corporation's fiscal year 1947, which, as indicated above, was greater than the agent's computation of \$74,984.96 (RAR, Ex. Q, p. 81), which was the basis for the deficiency assessment against Clark for his calendar year 1946. Accordingly, the taxpayers having demonstrably failed to carry their burden of proving error, the Tax Court, with more than ample justification, sustained the deficiency.

Before this Court taxpayers argue repetitively (Br. 17, 23-25) that the Tax Court should not have restored the \$63,488.47, referred to above, to distributable earnings of the corporation for its fiscal year 1947. There is clearly no merit in the contention. The \$63,488.47 is comprised of five items (R. 94-97)—*viz.*, Truman Johnson (\$6,000), H. L. Brittain (\$1,860.40), deferred sales income received in cash in fiscal 1947 (\$49,210.15), merchandise purchases deduction disallowed (\$2,714.42), and



bad debts deduction disallowed (\$3,703.50). All of these items were included by the agent in his total adjustments to gross income for fiscal 1947 (\$102,050.17, R. 91) which (as reduced to \$97,511 by the Tax Court's elimination of the Y. L. Creed item and the allowance of \$1,480.67 on account of the cashing of accommodation checks) is not contested. The amounts of each of the involved items are not and have never been in dispute. No affirmative evidence has been adduced by taxpayers to sustain their burden of proving error in the Commissioner's inclusion of these items in both fiscal 1947 income (which is not contested) and in distributable earnings for that year. Taxpayers' Witness Claypoole's testimony with respect to these items (R. 194-195) was not only inconclusive but vague, although he admitted that the deferred sales income might well have been represented by cash received. No affirmative value attaches to the testimony, however, since he admitted on cross-examination that he had not examined the books and records (R. 208) and had no knowledge of actual distributions (R. 211). He admitted further (R. 209-210), thus contradicting himself, that non-cash items can be distributed. Revenue Agent Phillips' testimony (R. 309-311) that he had reduced distributable earnings by these items was given in explanation of his adjustments made in Exhibit Q of his report, which, of course, is not in evidence for other than the limited purpose of showing the computation basis of the deficiency assessments. His testimony, accordingly, is in no way binding on either the Commissioner or the Tax Court. Moreover, as the Tax Court clearly pointed out (R. 94-97), the revenue agent's treatment of these items, distributable earnings-wise, was essentially based on the erroneous notion that to be distributable the item must be in cash. [Claypoole's admission to the contrary supports rather than refutes the Tax Court's treatment accorded all of these items.] Further, the fact that these items were all admitted income items, increasing the corporation's income for the year is proof, of itself, that they similarly increased



distributable earnings. Obviously, as the Tax Court pointed out (R. 95), there is no requirement that distributable income be in cash or in any particular tangible form or that it may be distributable only in the form in which it is earned. Essentially the determination herein made by the Tax Court with respect to includibility in earnings and profits is a legal determination, altogether properly within the province of the trial judge for determination. We are in complete accord with the specific reasons given by the Tax Court below (R. 94-97) for restoring each of these admitted fiscal 1947 income items to distributable earnings for the year and we adopt that reasoning as our own.

With respect to both Gene and Faye Clark's calendar year 1947, the Commissioner assessed deficiencies (R. 14, 34) based on each spouse's receipt of \$24,750.49 derived equally from Gene Clark, Inc.'s constructive dividend of \$49,500.99 for its fiscal year 1948. After adjustment for rectifiable errors in the agent's computation of this \$49,500.99 (\$43,376.22 plus \$8,262.34 less \$2,137.57 for a partial liquidating dividend charge to surplus) (RAR, Ex. Q, p. 81), the Tax Court determined deficiencies in a lesser amount, based on adjusted constructive dividends from the corporation in the total amount of \$39,782.58 (R. 151, 156).

As a computation basis for the assessed deficiencies, the revenue agent computed a total distribution of \$149,233.83 (RAR, Ex. Q, p. 81), which was predicated on (a) adjustments to net income by reason of unreported sales, substituted items (\$35,419.36) and other uncontested adjustments, which altogether totaled \$92,208.62; (b) four items totaling \$63,406.36; and (c) a deduction of \$6,381.15 for two items treated by the agent as non-available. All of the items included in the \$92,208.62 were stipulated or uncontested with the exception of one substituted item (Pacific Pumps, Inc.) of \$1,094.52 (R. 115), which the agent had included in error. The Tax Court made adjustment for this item, which reduced substituted items to \$34,324.84 and then made an additional allowance of

\$3,432.48 (R. 117) to the reduced sub-total on account of the cashing of accommodation checks (*Cohan v. Commissioner, supra*), the two adjustments serving to reduce the \$92,208.62 adjustment to net income to \$87,681.62 (R. 119). For reasons detailed in its opinion and not here opposed (R. 119-121), the Tax Court eliminated the four items, totaling \$63,406.36, which we have referred to, *supra*. The two items deducted in the combined amount of \$6,381.15 were held by the Tax Court (R. 119-120) to have been eliminated by the agent in error. The trial judge concluded (R. 120): "We think both are includible in available earnings for fiscal 1948 \* \* \*." However, in computing adjusted available earnings, the Tax Court apparently inadvertently omitted these two "includible" items and arrived at a figure of \$104,408.02 (R. 119), which represented the sum of the reduced net income adjustments of \$87,681.62, mentioned above, and \$16,726.40 (R. 59) the reported income on the fiscal 1947 tax return, which, inadvertently, the agent had omitted from his Exhibit Q computations (RAR, Ex. Q, p. 81). From this \$104,408.02 the Tax Court deducted (R. 121-122) accrued fiscal 1948 federal income tax (\$39,399.42) and Section 293(b) additions to tax for fiscal 1947 (\$19,979.69) (*Estate of Stein v. Commissioner, supra*; *Stern Brothers & Co. v. Commissioner*, 16 T.C. 295), totaling \$59,379.11, thus arriving at distributable earnings for fiscal 1948, in the amount of \$45,028.91 (R. 122).

The Tax Court next computed (R. 122) actual distributions for fiscal 1948 by deducting the elimination items totaling \$63,406.36 (uncontested) from the agent's computed total distribution figure of \$149,233.83 (also uncontested) to arrive at a net amount of \$85,827.47. The trial judge then pointed out (R. 122-123) that while accrued federal taxes and prior year Section 293(b) civil fraud penalties are properly deductible from adjusted net income for purposes of determining distributable earnings (*viz.*, \$45,028.91, *supra*) actual distributions are computed without the tax and fraud penalty accrual de-

duction "because actual distributions may, and often do, exceed available earnings, the excess being in the nature of liquidating dividends" (R. 123).

It is to be observed that all of the foregoing adjustments, with the possible exception of the elimination of the Pacific Pumps item and the *Cohan* rule allowance for accommodation checks were properly made at the Tax Court's initiative by way of correcting obvious omissions and apparent errors in the revenue agent's computation of the fiscal 1948 constructive dividends. The Tax Court expressly pointed out, however (R. 123), that apart from these adjustments "petitioner has failed to meet the burden of proving error in respondent's determination." Accepting the actual total distribution figure of \$85,827.47, as computed above, the Tax Court first applied against this amount the \$45,028.91, representing earnings available for distribution as ordinary dividends. The balance of \$40,798.56, not being covered by earnings and profits, is, of course, properly to be treated as a liquidating dividend. *Drybrough v. Commissioner*, 238 F. 2d 735 (C.A. 6th), affirming in part and reversing on another issue *United Mercantile Agencies, Inc. v. Commissioner*, 23 T.C. 1105. However, since the value of Clark's stock was stipulated by the parties to be \$61,214.49 (R. 82, 133) and the 70 per cent of this liquidating dividend allocable to Clark—*viz.*, \$28,558.99 (R. 123)—did not equal the stock's basis, the Tax Court correctly held that the additional liquidating distribution of \$40,789.56 was not material to either spouse's individual tax liability for calendar year 1948.

Under the Tax Court's reconstruction of the adjusted corporate constructive dividend of \$45,028.91 for fiscal year 1948, Clark's 70 per cent share was \$31,520.24 (R. 123-124), which, dollar-wise, was substantially lower than the agent's allocation of \$41,238.65 to Clark (RAR, Ex. Q, p. 81), the fiscal 1948 constructive dividend which together with the \$8,262.34 (R. 110) allocated from fiscal year 1946, formed the basis for the deficiencies (\$49,-

500.99) assessed against the Clarks, community property-wise, for their calendar years, 1947. Since the total distribution for fiscal year 1948 amounted to \$85,827.47 and the distributable earnings, which must be taken off first in determining taxable ordinary dividends, amounted to \$45,028.91 (of which \$31,520.24 was attributable to Clark), the Tax Court had ample basis for holding, absent taxpayers' adducement of any affirmative proof to the contrary, that (R. 124):

On any appropriate basis of allocation of distributions (\$85,827.47) from fiscal 1948 to calendar 1947 (which included eight months of fiscal 1948), the distributions attributable to calendar 1947 would be at least sufficient to encompass total ordinary dividends including the \$31,520.24 attributable to Clark.

There is no merit in taxpayers' contention (Br. 9-10, 25-26, Exs. E and F, Appendix 5-9) that the allocation of Clark's entire share of the fiscal 1948 constructive dividend to the Clarks individual calendar year 1947 was anything other than reasonable. As the Tax Court pointed out (R. 123-124) the principle of federal tax law is axiomatic that when total distributions (\$85,827.47) represent both distributable earnings and a partial return of capital, the distribution must *first* be applied against the available earnings and profits (\$45,028.91) for distribution as ordinary dividends. *Drybrough v. Commissioner, supra*. Accordingly, any reasonable basis of allocation, here, would have to attribute both the entire \$45,028.91 and some additional portion of the remaining liquidating dividend (\$40,798.56) to calendar year 1947 were it not for the fact that Clark's stock basis was so high that no additional portion of the \$40,798.56 could here be treated as calendar 1947 ordinary income. Again, the self-contradictory admission by the taxpayers' own witness, Claypoole (R. 207), that year-end earnings and profits determine the ordinary dividend treatment to be accorded prior distributions, amounts to tacit agreement with the basic federal tax principle here involved.



Further, taxpayers so-called Exhibits "E" and "F" (Appendix 5-9), which they admit [at least as to Exhibit "E" (Br. 32)] "are not based upon the evidence in this case," amount to nothing more than self-serving computations based, in many respects, on arithmetical distortions of various figures picked at random from the different schedules and exhibits in the revenue agent's report.<sup>11</sup> Next, as a simple matter of arithmetic, it is observable that, on a straight line allocation between calendar years 1947 and 1948, by months, the \$31,520.24 allocated to the Clarks from the \$60,079.23 portion of the total distribution (\$85,827.47), representing his 70 per cent share of the fiscal 1948 distribution, is considerably less than the \$39,949.56, which represents 66 2/3 per cent of Clark's fiscal 1948 share attributable to calendar year 1947, eight months of which were included in such fiscal year. Finally, the fact remains that taxpayers have failed utterly to carry their burden of proving error in the reduced calendar 1947 deficiencies, as adjusted downward by the Tax Court.

**B. *The Tax Court did not err in finding and concluding that the Commissioner had sustained his burden of proving fraud***

Section 293(b) of the Internal Revenue Code of 1939 (Appendix, *infra*), provides that "If any part of any deficiency is due to fraud with intent to evade tax" then 50% of the deficiency shall be added thereto. It has

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<sup>11</sup> For example, the \$5,080.40 fiscal 1948 deferred income item, which the Tax Court, possibly inadvertently, left out of account altogether in reconstructing total fiscal 1948 distributions, is included by taxpayers in their Exhibit "F" summary (Appendix 9) not once but twice. Included in such summary is a \$39,300.87 item for "Unreported Income \* \* \* in Other Bank Accounts" which did not enter into the Tax Court's consideration at all and is accordingly irrelevant, except as evidence of Clark's disposition of appropriated cash. In Exhibit "E" taxpayers include in their computation of earnings and profits \$63,488.47 which was not even treated by the Tax Court as a figure applicable to that fiscal year.



been held that these plain words leave no room for construction. *Mauch v. Commissioner*, 113 F. 2d 555 (C.A. 3d).

The Tax Court found (R. 83):

Each of the returns of Gene Clark for the years 1946 and 1947 was false and fraudulent with intent to evade tax within the meaning of section 276(a) of the Internal Revenue Code of 1939. A part of the deficiency of Gene Clark for each of the years 1946 and 1947 was due to fraud with intent to evade tax within the meaning of section 293(b).

The Tax Court concluded (R. 134-137), on the basis of an examination of the entire record, with such scrutiny not being limited to a consideration of the Commissioner's affirmative evidence (R. 134), that Gene Clark's "intent to defraud is abundantly established" (R. 136). Specifically, the Tax Court concluded with respect to the 1946 deficiency (R. 137-140) that, on the basis of the entire record (R. 137-138) and on the basis of at least two selected specific transactions (R. 138-140), at least a part of the deficiency for calendar year 1946 was due to fraud with intent to evade tax. He reached the identical conclusion (R. 140-142) with respect to Clark's calendar 1947 deficiency, on the basis of both the over-all record and, specifically, on the basis of three selected transactions.

It remains to consider the applicable legal principles and the proof.

The burden of proof of fraud, as the Tax Court observed (R. 134), rests upon the Commissioner. Section 7454(a) of the Internal Revenue Code of 1954. It is well settled that whether an understatement of income is due to fraud presents solely a question of fact, and that the Tax Court's determination in respect thereof is final if supported by clear and convincing evidence and is not shown to be clearly erroneous. *Helvering v. Kehoe*, 309 U. S. 277, 279; *Carmack v. Commissioner*, 183 F. 2d 1 (C.A. 5th), certiorari denied, 340 U. S. 875; *Davis v.*

*Commissioner*, 239 F. 2d 187 (C.A. 7th), certiorari denied, 353 U. S. 984; *Bodoglau v. Commissioner*, 230 F. 2d 336 (C.A. 7th); *Halle v. Commissioner*, 175 F. 2d 500, 503-504 (C.A. 2d), certiorari denied, 338 U. S. 949; *United States v. Gypsum Co.*, 333 U. S. 364, 394-395, rehearing denied, 333 U. S. 869; Rule 52(a), Federal Rules of Civil Procedure.

In proving fraudulent intent the Commissioner has to show only that some part of each deficiency was due to fraud with intent to evade tax. Section 293(b) of the 1939 Code, *supra*. While "Fraud is not to be lightly inferred, but must be established by clear and convincing proof" (*Rogers v. Commissioner*, 111 F. 2d 987, 989 (C.A. 6th)), yet the obligation of the Commissioner to prove it relates only to the fraud penalty and not the correctness of the deficiency (*Cohen v. Commissioner*, 9 T.C. 1156, affirmed, 176 F. 2d 394 (C.A. 10th); *United States v. Chapman*, 168 F. 2d 997 (C.A. 7th), certiorari denied, 335 U. S. 853). Moreover, "there is no burden upon the Government to prove its case beyond a reasonable doubt". *Helvering v. Mitchell*, 303 U. S. 391, 403; *Spies v. United States*, 317 U. S. 492, 495.

Bearing these well established legal principles as to burden and proof in mind, the Tax Court concluded, under the entire record here before the Court, that (R. 135) "the intent to defraud is established beyond question." As clear and convincing proof of such conclusion, drawn from the entire record, the Tax Court then detailed the following "badges of fraud", which pervade the entire record (R. 135-136):

(a) Substantial (though undetermined) amounts of receipts from sales made by Gene Clark, Inc., were neither recorded on its books nor reported on its income tax returns. [See testimony of Government witnesses, affirmatively adduced: Y. L. Creed (R. 213-219); Truman Johnson (R. 220-226); Ben Lang (R. 227-229); Frances B. Bittinger (R. 229-232); and of Lloyd George Meissenburg (R. 232-240) as to particular transactions they or

their customer firms had with Gene Clark, Inc. See, further, the testimony of Government Witness Files (R. 240-287) affirmatively adduced to show the control asserted by Clark over books and records throughout the 1946-1947 fiscal years, particularly with respect to handling cash (R. 244-248); the practice of not recording certain sales and the substituted check practice consistently followed incident thereto (R. 249-251); the withholding of certain sales invoices (R. 257-258); the purchase of the Kansas farms with corporate funds (R. 271-274); the retention by Clark of the corporation's only declared cash dividend notwithstanding an offsetting debit to "Notes Receivable—Officers," covered by substituted checks (R. 281-282), etc. [See particularly the testimony of Revenue Agent Phillips (R. 287-315), during the course of which (R. 290-305), the taxpayers' counsel stipulated to the fact that virtually all of the contested sales transaction items added to fiscal 1947 and 1948 net income by the agent were either unrecorded and unreported and/or substituted check transactions.]

(b) Substantial amounts of cash passed to Clark personally. [See the third-party customers' testimony, *supra*, as to transactions giving rise to Clark's receipt of sales proceeds which were neither recorded or reported. See Files' testimony as to Clark's receipt of \$12,000 cash from Valley Boulevard Plumbing & Electric Company (R. 254-255).]

(c) Clark's express admission (R. 366) that, being in control, it was his own idea not to record certain sales as a means of withholding cash from the corporation and that he directly participated in such diversions. [See Clark's numerous admissions as to profits on unreported over-ceiling sales of materials (R. 362-363); his failure to account for profits (R. 367); his practice of taking personal charge of cash (R. 374); his receipt of \$12,000 cash from Meissenburg (R. 336-337); his receipt of other Meissenburg monies (R. 342); etc.]

(d) Clark's instructions to his comptroller, Files, to have certain cash receipts from sales set aside, with

the transaction being unrecorded and the proceeds being turned over personally to him. (R. 374.)

(e) Clark's substituted check practice, consistently followed throughout the period—*viz.*, recorded but undeposited sales being covered by depositing substituted third party customer checks received incident to unrecorded sales transactions—with the withheld cash going to Clark personally. [See Clark's express admissions (R. 364-368), coupled with this counsel's stipulations, during the course of Revenue Agent Phillips' testimony (R. 287-305) as to the fact of substitution; specifically, for example, in the case of the three Hamilton Homes, Inc., substituted checks (R. 296-297, etc.)]

(f) Clark personally sold plumbing materials from the El Monte (main) office without accounting for or recording the proceeds on the books of the company. [See testimony of Government Witness Files that: No records were kept of cash withheld by Clark (R. 245); he knew inventory was removed from stock at El Monte shop which was unrecorded (R. 246); such unrecorded sale of materials was a regular recurrence (R. 249-250); the corporation's initial inventory was taken over from Gene Clark Plumbing and purported to be the entire inventory (R. 260-262); and no books were kept for Gene Clark Plumbing (R. 257-258). Further, see admissions of Clark that: No records were kept on sale of materials (R. 331-332); he took the Gene Clark Plumbing inventory at time of incorporation himself (R. 356); such inventory record was no longer available (R. 324-325); he received cash from the sale of materials (R. 331); the \$12,000 cash received from Meissenburg was undeposited (R. 338); and inventory trading transactions were unrecorded (R. 333-334).]

(g) Clark engaged in over-ceiling sales without accounting for all the proceeds or profits therefrom. [See Clark's admissions that the practice continued throughout the period at a profit (R. 361-362); also, that the corporation never reported this profit (R. 363).]



(h) Neither Gene Clark, Inc., nor Gene Clark reported the proceeds from over-ceiling material sales on their tax returns. [See Clark's admissions to this express effect. (R. 362-363, 364.)]

Summarizing the foregoing "badges of fraud" (R. 135-136), the Tax Court stated its opinion (R. 136) that Clark's alleged explanations for his use of the substantial amounts of cash admittedly received—*viz.*, that he needed it for the purpose of plumbing materials at over-ceiling prices—was unworthy of belief. As developed above, he had no inventory records of the materials on hand when the corporation was formed (R. 331-332, 324-325) and he had no available record of the amounts he claimed to have spent for over-ceiling priced materials (R. 330). His bookkeeper, Files, testified (R. 268) that no records were kept of trading transactions in materials. The taxpayers' witness, Claypoole, admitted (R. 208) he had never examined the books and records of the corporation. Finally, whereas Clark testified (R. 328-329) he made extensive purchases at over-ceiling prices from a Mike Harvey at Tyler Foundries; in Texas, Harvey was not called as a witness to corroborate such testimony. Under these circumstances, due consideration should properly be accorded the Tax Court's opportunity to see and judge the credibility of the witnesses. *Quock Ting v. United States*, 140 U. S. 417; *Davis v. Commissioner*, 239 F. 2d 187, 190 (C.A. 7th), certiorari denied, 353 U. S. 984; *Bryan v. Commissioner*, 209 F. 2d 822 (C.A. 5th), certiorari denied, 348 U. S. 912; *Boyet v. Commissioner*, 204 F. 2d 205 (C.A. 5th).

With specific reference to Clark's calendar year 1946 (R. 137-140), the Tax Court pointed to the evidence of Files (R. 137), detailed above, with respect to Clark's unrecorded and unreported sales and diversions of corporate funds in substantial but not precisely calculable amounts as giving rise to the reference of fraud. Further, he pointed out that since the corporation reported income for the fiscal 1947 year, indicating earnings avail-

able for distribution, there can here be no doubt (R. 137) that the diversions during the last eight months of the calendar year 1946 represented, at least in part, constructive dividends to Clark which were not included in the separate calendar 1946 returns filed by himself and his wife.

This circumstantial evidence of fraud while altogether clear and convincing is buttressed substantially by Clark's express admissions with respect to his control over and receipt of cash from unrecorded and unreported transactions as well as by the admitted failure to keep adequate books and records. Indeed, it would be difficult to marshal more clear and convincing proof of an affirmative nature in support of the Commissioner's burden to prove a part, at least of the 1946 deficiency was due to fraud with intent to evade tax.

However, the Tax Court proceeds (R. 138-140) to present an analysis of the pre-incorporation Y. L. Creed transaction and the Truman Johnson transaction whereby plumbing contract work performed by Gene Clark, Inc., was intentionally arranged between the parties in such a manner that the agreed price and the amount deposited failed to reflect the true nature of the transactions. In the Creed transaction, Clark performed plumbing work for which Creed agreed to pay \$2,922.50. Before incorporation of Gene Clark, Inc., Creed paid \$544 which was deposited to the account of Gene Clark Plumbing. Later, in June 1946, after incorporation, Creed credited Clark personally with the balance of \$2,378.50 on his purchase of one of Creed's houses. The credit was never reported by either Clark, individually, or in the corporation's fiscal 1947 return. (R. 302.) Since earnings and profits existed in the corporation to more than cover the item, and since, alternatively, the item, as credited, would otherwise be income to Clark, individually, in calendar year 1946, it becomes obvious that some part of Clark's calendar year 1946 deficiency was due to the omission to report. Before the Tax Court, Creed was called as a

government witness (R. 213-218) and testified (R. 218) that the balance of \$2,378.50 was credited to Clark on his purchase from Creed of a \$8,500 house, as of June 13, 1946 (R. 215). The Truman Johnson transaction (R. 139-140) consisted of an October 5, 1946, corporation contract to supply plumbing materials and services on ten houses Johnson was building, at an agreed price of \$9,300. At Clark's request (R. 223) and over Government Witness Johnson's objection (R. 226), the price was set in the written contract at \$3,300 (instead of \$9,300, the actual price). The difference of \$6,000 was credited by Johnson to Gene Clark, Inc., on a house which the corporation purchased from Johnson in 1946. (R. 223.) (The house was sold by the corporation to Clark in 1947.) Johnson's books recorded the full cost of the materials and services, furnished, including the \$6,000. (R. 224.) The \$6,000 was neither recorded on the corporation's books nor reported on its income tax returns.

With respect to the clear import of these specific transactions, the Tax Court, we submit correctly, stated (R. 139-140):

Here Clark's intention to defraud was deliberate and obvious. While in the first instance, the fraud from the income tax standpoint affected the tax of the corporation, it likewise had its effect upon the income and tax of Clark arising out of diversions from the corporation by Clark, which, to the extent of the actual diversions, and not to exceed available earnings, are to be treated as ordinary dividends. Whether or not Clark was familiar with all of the income tax accounting factors involved is not material. His intent was to defraud, both as to himself and the corporation, and he succeeded.

Accordingly (R. 140), the Tax Court held that Clark's calendar 1946 tax return was false and fraudulent with the obvious intent to evade taxes and that some part of his calendar 1946 deficiency was due to fraud with intent to evade taxes, within the meaning of Section 293(b) of the 1939 Code.

With specific reference to Clark's calendar year 1947 (R. 140-142), the Tax Court first pointed out that the same pattern of unrecorded corporate sales, with diversion of corporate funds to Clark, who, in turn, failed to report such receipts, prevailed during calendar year 1947, as was the case in 1946.

With respect to specific instances of fraud, the Tax Court selected the three payments (totaling \$5,686) from Hamilton Homes, Inc. (R. 140-141), the \$1,000 H. K. Niles transaction (R. 141), and the \$2,731.54 Valley Cities Supply Company transaction (R. 141) as clear examples. During the course of Government Witness Frances B. Bittinger's testimony, the taxpayers' counsel stipulated (R. 230) that the three Hamilton Homes checks were issued to Gene Clark, Inc., in payment of sales invoices. During the course of Revenue Agent Phillips' testimony, the taxpayers' counsel stipulated (R. 296-297) that all three Hamilton Homes checks, issued in July and September, 1947, were not recorded on the corporations books or reported on either the corporation's or the taxpayer's tax returns. Similar stipulations were entered into with respect to the H. R. Niles checks (R. 297) and the Valley Cities Supply Company (R. 295). Taxpayers' further stipulated (R. 297) that these items were deposited by Gene Clark, Inc. On the basis of such agreed facts, the Tax Court pointed out (R. 140-141) that such deposits necessarily substituted these checks, arising out of unrecorded and unreported transactions, for undeposited payments from other customers on recorded transactions. As the trial court pointed out (R. 141) while Clark did not expressly concede these particular substitutions, he admitted (R. 365-367): That he understood the substitution practice; that it was his idea; that substitutions were made; that the proceeds or profits were not accounted for; and that the practice was continued throughout the period (R. 393). Accordingly, since the sales per books, per returns, and the bank deposits reconciled (as to totals) with each other (R. 463-464), the Tax Court pointed out



(R. 141), we submit correctly, that the only possible inference or explanation is that substitutions of checks (received for unrecorded sales) for previously undeposited and diverted proceeds of recorded sales were made. Accordingly, the Tax Court concluded (R. 141):

That at least a substantial part of the undeposited amounts went to Clark is obvious \* \* \*. Here again, it is not significant on the fraud issue to place a label on the diversions. There were ample earnings of the company available for distribution as ordinary dividends. Thus, whether we treat the diversions as ordinary dividends or direct income to Clark, the result is the same. The income was not reported by Clark or his wife.

Accordingly (R. 142), the Tax Court held that the income tax return of Gene Clark for calendar year 1947 was false and fraudulent, with intent to evade taxes, and that part of his deficiency for 1947 was due to fraud with intent to evade taxes.

It remains to observe that there is nothing of merit in the taxpayers' contention (Br. 28-31) which should here be viewed as disturbing the Tax Court's findings and conclusions with respect to Clark's liability for the assessed additions to tax under Section 293(b) for his calendar years 1946 and 1947, to the extent here in issue. Under the entire record, embracing both the Commissioner's compelling affirmative proof adduced and the taxpayer's fatally damaging admissions, both on the stand and by stipulation, it would be difficult to hypothesize a case wherein the Commissioner might more clearly and convincingly sustain his burden of proving fraud, within the meaning of the statute.

***C. Section 275(c) is no bar to the assessment and collection of the deficiencies***

We have shown in A and B, above, that the taxpayers have failed to sustain their burden of proving error in the deficiencies, as assessed against Gene Clark for his

calendar year 1946, and as assessed, and adjusted, with respect to both spouses' calendar years 1947, and, also, that the Commissioner has sustained his burden of proving, by clear and convincing evidence, that at least part of the deficiencies assessed against Gene for his calendar years 1946 and 1947 was due to fraud with intent to evade tax, within the meaning of Section 293(b) of the Internal Revenue Code of 1939. It remains to point out that, in view of the fact that the taxpayers each omitted properly includible amounts from gross income in his and her calendar 1947 returns, which were in excess of 25 per centum of the amounts of gross income stated in such returns, that the five year statute of limitations provided for in Section 275(c) of the 1939 Code (Appendix, *infra*) is no bar to the assessment and collection of the two calendar 1947 deficiencies.

With respect to Gene Clark, it must be observed that his filing of false and fraudulent returns for calendar years 1946 and 1947, as demonstrated above, in and of itself tolls any statute of limitations bar to the assessment and collection of his deficiencies. However, since both spouses filed separate calendar 1947 returns, on a community property basis, on March 15, 1948 (R. 20, 40), and since their 1947 deficiencies were both assessed on February 20, 1953 (R. 10, 30), with the finally determined additional 1947 gross income here in issue being attributed to each on a community property basis, the reasons here advanced in support of the validity of Faye's adjusted deficiency would apply with equal force to Gene's, were it not for the fact that the fraud attaching to his calendar 1947 return keeps the year open, in any event.

Under the facts, it is altogether clear that Section 275(c) is no bar to either spouse's 1947 deficiency. On March 15, 1948, both spouses filed their calendar 1947 returns, with each reporting gross income of \$9,130.51. (R. 18, 38.) The statutory notice of deficiency was transmitted to each, on February 20, 1953 (R. 10, 30), more than three but less than five years after the returns were

filed. No waivers were filed. As a matter of arithmetic, 25 per centum of the \$9,130.51 reported by each spouse on the 1947 return is \$2,282.63. Since the applicability of Section 275(c) was raised by the Commissioner in the answer (R. 20, 40), the burden of proof is on him. He need not, however, establish a precise amount so long as it is apparent from the affirmative evidence that at least \$2,282.63 (25 per cent of the reported calendar 1947 gross income, per the return) was omitted.

We submit that the Tax Court was entirely correct in holding (R. 143) that the Commissioner altogether clearly met his burden of proving the omission of at least \$2,282.63 from both spouses' calendar 1947 returns, as filed. The arithmetical demonstration is quite simple and has been set forth in Part B above, in showing that the Commissioner adduced affirmative proof, on the specific calendar 1947 fraud issue that Gene Clark, Inc., understated its gross income by \$9,417.54, by failing to record or report its receipt of the five substituted checks from Hamilton Houses, Inc. (three checks totaling \$5,686), H. K. Niles (\$1,000), and Valley Cities Supply Company (\$2,731.54). As has been shown above, 70 per cent of this total amount—*viz.*, \$6,592.28—constituted gross income diverted from the corporation by Clark to be accounted for on the elected community property basis in their separate returns for 1947. Again for the reasons stated with respect to the fraud issue, it is a distinction without a difference as to whether the items be deemed direct income to Clark and his wife or constructive dividends. They represent gross income in either event, and one-half of Clark's share of each was includible, on the community property basis, in gross income on Faye's individual return for 1947. The amount so omitted from gross income on her return which should have been included therein—*viz.*, \$3,296.14—was well in excess of \$2,282.63, and the statute of limitations, therefore, is not a bar to assessment as to Faye Clark for 1947, or, for that matter, as to Gene, absent the fraud attaching to

his return, which, of course, frees the assessment and collection from the statute altogether. The question of intent on the part of Faye is no way material to this issue.

Finally, it may be observed that there is no merit in the taxpayers' contention (Br. 32-33) to the contrary. We have already demonstrated in Part B, *supra*, the fallacious self-serving conclusions they allege in their Exhibits "D" and "E" which as they themselves admit (Br. 32) do not stand as record evidence. They have adduced no proof whatsoever to refute the affirmative evidence adduced by the Commissioner, which was far more than enough to sustain his burden of proving at least the required \$2,282.63 omission from gross income reported by both spouses in their 1947 returns.

## CONCLUSION

The decisions of the Tax Court should be affirmed.

Respectfully submitted,

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## APPENDIX

Internal Revenue Code of 1939:

## SEC. 22. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. \* \* \*

\* \* \* \*

(26 U.S.C. 1952 ed., Sec. 22.)

## SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend*.—The term "dividend" when used in this chapter \* \* \* means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

\* \* \* \*

(b) *Source of Distributions*.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. \* \* \*

\* \* \* \*

(d) [As amended by Section 214(b) of the Revenue Act of 1939, c. 247, 53 Stat. 862] *Other Distributions from Capital*.—If any distribution made by a corporation to its shareholders is not out of increase in value of property accrued before March 1, 1913,

and is not a dividend, then the amount of such distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113, and if in excess of such basis, such excess shall be taxable in the same manner as a gain from the sale or exchange of property. This subsection shall not apply to a distribution in partial or complete liquidation or to a distribution which, under subsection (f) (1), is not treated as a dividend, whether or not otherwise a dividend.

\* \* \* \*

(26 U.S.C. 1952 ed., Sec. 115.)

#### SEC. 275. PERIOD OF LIMITATION UPON ASSESSMENT AND COLLECTION.

\* \* \* \*

(c) *Omission From Gross Income*.—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

\* \* \* \*

(26 U.S.C. 1952 ed., Sec. 275.)

#### SEC. 293. ADDITIONS TO THE TAX IN CASE OF DEFICIENCY.

\* \* \* \*

(b) *Fraud*.—If any part of any deficiency is due to fraud with intent to evade tax, then 50 per centum of the total amount of the deficiency (in addition to such deficiency) shall be so assessed, collected, and paid, in lieu of the 50 per centum addition to the tax provided in section 3612 (d) (2).

(26 U.S.C. 1952 ed., Sec. 293.)